



COMMONWEALTH OF VIRGINIA

VIRGINIA DEPARTMENT OF TAXATION

Field Audit Procedures

Revisions:
April 2023
December 2016
December 2012

Field Audit Procedures – Sales & Use Tax



Topic: Agriculture

Revised: December 2012

I. References

- A. Code of Virginia:
 - 58.1-609.2
- B. Virginia Administrative Code:
 - 23 VAC 10-210-50
 - 23 VAC 10-210-280(C)(5)
- C. Public Documents:
 - Agricultural Cooperative Association – PD 96-291
 - Alpacas – PD 05-113
 - Ancillary Activities – PD 97-280; PD 09-153
 - Animal Health Products – PD 05-26
 - ATV Usage – PD 04-195; PD 05-133
 - Canine Breeding – PD 09-31
 - Dairy Farms – PD 87-156
 - Eggs – PD 11-98; PD 11-175
 - Exotic Animals – PD 92-250
 - Farm Equipment (Lease/Rental) – PD 91-113; PD 96-120; PD 04-165
 - Farm Vehicles (Repair & Maintenance) – PD 94-301; PD 96-34
 - Feed Tanks/Bins – PD 97-17; PD 99-27
 - Fencing (Permanent) – PD 98-197; PD 05-158
 - Fish Farming – PD 89-223
 - Fuel – PD 01-81
 - Golf Carts – PD 97-27
 - Grain Drying – PD 94-68
 - Gravel & Crushed Stone – PD 95-33
 - Greenhouse – PD 04-69; PD 09-153
 - Harvesters – PD 10-152
 - Hay – PD 09-100
 - Hogs – PD 97-454
 - Horses – PD 86-29; PD 88-231; PD 91-129; PD 91-174; PD 91-294; PD 93-5; PD 93-74; PD 93-100; PD 94-324; PD 04-162; PD 07-43
 - Irrigation Controllars – PD 93-93
 - Livestock – PD 96-69; PD 09-120
 - Occasional Sale (Agricultural Products) – PD 00-126
 - Ostriches – PD 94-152
 - Plant Coverings – PD 00-207; PD 09-101
 - Poultry – PD 98-8; PD 06-73
 - Silos – PD 86-58
 - Tobacco Barns – PD 89-288
 - Vaccination Machinery – PD 96-349
 - Veterinary Supplies – PD 89-125; PD 97-139

Vineyard – PD 99-85
Weed Control Products – PD 94-311
Weed Eaters/Small Motorized Equipment – PD 07-58
Welding Equipment/Supplies – PD 06-7

- D. Exemptions Certificates:
ST-18
ST-15 (*discontinued and still valid, but should be replaced with an ST-18*)

II. General

Code of Virginia § 58.1-609.2 exempts the following:

- A. Commercial feeds; seeds; plants; fertilizers; liming materials; breeding and other livestock; semen; breeding fees; baby chicks; turkey poults; rabbits; quail; llamas; bees; agricultural chemicals; fuel for drying or curing crops; baler twine; containers for fruit and vegetables; farm machinery; medicines and drugs sold to a veterinarian provided they are used or consumed directly in the care, medication, and treatment of agricultural production animals or for resale to a farmer for direct use in producing an agricultural product for market; tangible personal property, except for structural construction materials to be affixed to real property owned or leased by a farmer, necessary for use in agricultural production for market and sold to or purchased by a farmer or contractor; and agricultural supplies provided the same are sold to and purchased by farmers for use in agricultural production, which also includes beekeeping and fish, quail, rabbit and worm farming for market.
- B. Every agricultural commodity or kind of seafood sold or distributed by any person to any other person who purchases not for direct consumption but for the purpose of acquiring raw products for use or consumption in the process of preparing, finishing, or manufacturing such agricultural or seafood commodity for the ultimate retail consumer trade, except when such agricultural or seafood commodity is actually sold or distributed as a marketable or finished product to the ultimate consumer. "Agricultural commodity," for the purposes of this subdivision, means horticultural, poultry, and farm products, livestock and livestock products, and products derived from bees and beekeeping.
- C. Livestock and livestock products, poultry and poultry products, and farm and agricultural products, when produced by the farmer and used or consumed by him and the members of his family.
- D. Machinery, tools, equipment, materials or repair parts therefor or replacement thereof; fuel or supplies; and fishing boats, marine engines installed thereon or outboard motors used thereon, and all replacement or repair parts in connection therewith; provided the same are sold to and purchased by watermen for use by them in extracting fish, bivalves or crustaceans from waters for commercial purposes.
- E. Machinery or tools or repair parts therefor or replacements thereof, fuel, power, energy or supplies, and cereal grains and other feed ingredients, including, but not limited to, drugs, vitamins, minerals, nonprotein nitrogen, and other supplements or additives, used directly in making feed for sale or resale. Making of feed shall include the mixing of liquid ingredients.

- F. Machinery or tools and repair parts therefor or replacements thereof, fuel, power, energy or supplies, used directly in the harvesting of forest products for sale or for use as a component part of a product to be sold. Harvesting of forest products shall include all operations prior to the transport of the harvested product necessary for (i) removing timber or other forest products from the harvesting site, (ii) complying with environmental protection and safety requirements applicable to the harvesting of forest products, (iii) obtaining access to the harvesting site, and (iv) loading cut timber or other forest products onto highway vehicles for transportation to storage or processing facilities.
- G. Agricultural produce, as defined in § 3.2-4738, and eggs, as described in § 3.2-5305, raised and sold by an individual at local farmers markets and roadside stands, when such individual's annual income from such sales does not exceed \$1,000.

III. Procedures

A. Audits of Farmers

1. Retail Sales - A farmer regularly engaged in selling tangible personal property at retail must register as a dealer and collect and pay the tax due on retail sales. A limited exemption from collecting sales tax is available for eggs and agricultural products sold by the individual who has raised the products if the individual's annual sales of such items do not exceed \$1,000.

There are programs in which members pay for a share of produce in advance of the growing season as an investment in the farm and receive produce deliveries throughout the season. These membership fees, initiation dues, or annual fees which entitle the members of the group to tangible personal property are subject to the tax at the time the fees are paid.

2. Purchases - A farmer can purchase all items necessary for agricultural production exempt. Tangible personal property incorporated into realty is generally taxable, except for specific structural materials. Some items can be used in both taxable and exempt activities. Such purchases are prorated based on their usage. All purchases for personal or family use or consumption are taxable.

A "custom farmer" does not enjoy the agricultural exemption. Custom farmers generally do not raise an agriculture product for sale. Instead they provide a "service" for farmers where the custom farmer has equipment to harvest crops for the farmer. These typically may be corn pickers, combines and hay balers.

B. Audits of Suppliers.

1. Form ST-18 - Form ST-18 is the proper certificate for use by both in state and out of state farmers. Form ST-11A is for use by construction contractors to purchase tangible personal property necessary for agricultural production, to be affixed to real property (feeding, milking systems, lighting fixtures in poultry houses, etc.). The contractor must obtain the ST-11A from Richmond. Exemption certificates should be examined carefully. They must be completely and correctly filled out. The ST-18 Exemption Certificate is not a

blanket exemption certificate. The certificate lists the items which can be purchased exempt.

2. Whole Goods – Depending upon the size of the supplier, it is recommended to perform a detail audit of sales of farm equipment, generally referred to as whole goods.
3. Parts and Repair Items – Parts and repair invoices should be sampled. Keep in mind the seasonal cycles of the farmer. There are the planting, growing and harvesting months to be considered when selecting the sample months.

C. Listing of Exempt and Taxable Items

The following list is taken from Commerce Clearing House, Virginia Tax Reports, Sales and Use Section (CCH-ANNO, VA-TAXRPTR ¶¶60-250.13), COPYRIGHT 2000, CCH Incorporated. It includes additions and other changes from the original printing by CCH. CCH's source is *Memorandum of Sales and Use Tax Division*, October 20, 1966 (as revised October 1, 1967, and February, 1971).

1. Agricultural exemptions - Tangible personal property listed in Items a through h below is exempt from the Virginia retail sales and use tax when purchased by a farmer for his use in agricultural production for market
 - a. Commercial feeds and seeds purchased by a farmer for his use in agricultural production for market.
 - Feed for breeding and other livestock
 - Feed for poultry
 - Seeds
 - b. Fertilizers and liming materials purchased by a farmer for his use in agricultural production for market.
 - c. Poultry purchased by a farmer for his use in agricultural production for market.
 - Baby chicks
 - Ducklings
 - Geese
 - Guineas
 - Hatching eggs
 - Turkey poults
 - d. Agricultural chemicals such as herbicides, pesticides, insecticides, fungicides, defoliant, disinfectants, and cleaning materials purchased by a farmer for his use in agricultural production for market.
 - e. Fuel for drying or curing crops purchased by a farmer for his use in agricultural production for market.
 - f. Twine and containers, including bags and wrapping materials, purchased by a farmer for his use in agricultural production for market.

- g. Farm machinery and equipment, and parts therefore, purchased by a farmer for his use in agricultural production for market.

Automatic feeding and watering equipment for poultry and livestock including electrical wiring to on/off switch.

Bush hog or like equipment used on a farm to cut over existing pasture land

Cab covers for farm equipment and machinery when attached at factory or added later

Dusting and spraying equipment

Farm water systems for poultry and livestock

Feed grinders and mixers

Front-end loader attached to a farm tractor when attached at factory or added later

Grading and packaging equipment for agricultural products

Grain and hay drying machinery

Grain and seed cleaning machinery

Hand operated pruning equipment, power pruning equipment and power saws for use exclusively in pruning fruit and nut trees.

Milking machines including electrical wiring to on/off switch

Bulk milk tanks and pipeline milking systems

Compressors for milking machines

Generator (including portable) to operate milk machines or other exempt agricultural machinery

Milk cans

Milk coolers

Strainers and milk buckets

Parts for unlicensed vehicles used exclusively on the farm. Parts for unlicensed farm vehicles as well as farm vehicles licensed as such. Restrictions such as the transportation of agricultural products to market and personal non-farm use would be subject to proration by the farmer

Peanut pickers and peanut drying machinery

Portable bins or tanks for use in feeding poultry and livestock (Bins and tanks for storage of agricultural products for market are taxable)

Portable elevator machinery used to load harvested crops into storage facilities on the farm

Portable irrigation equipment

Scales portable only

Power steering for agricultural equipment and machinery

Pruning equipment and chainsaws when used by orchardmen,
Christmas tree farmer, vineyard

Silo unloading and conveyor machinery

- h. Other agricultural items purchased by a farmer for his use in agricultural production for market.

Baler twine

Bobcat type machinery used to clean dairy barn, poultry, etc

Brooms and other commodities for use in cleaning dairy barns, hog parlors, poultry houses and other buildings used to produce an agricultural product for market

Clippers, shears, and grooming tools used on livestock that will become an agricultural product for market

Covering materials, such as canvas or plastic, or the like, for farm crops and farm supplies

Ear tags, neck chains, ID tags or adhesive stickers

Fluorescent lamps and bulbs and light fixtures used in feeding poultry

Freezers when used to hold dead animals

Fuel, oil, grease, and antifreeze for farm machinery or unlicensed vehicles used on the farm as well as farm vehicles licensed as such

Grain shovels, hay forks, hoes, scoops for use in cleaning dairy barns, hog parlors, poultry houses and other buildings used to produce an agricultural product for market

Hot water heater for use in dairy barn

Leaf blowers to clean chicken houses

Litter and/or bedding material for poultry and livestock

Obstetrical gloves and chains used in removing a calf at birth

Paint for farm machinery (Paint for any building or structure that is a part of real estate is taxable)

Portable heater for use in a milking barn

Posthole digger for planting fruit and nut trees

Poultry and hog equipment such as heaters, light bulbs, and brooders

Posts and wire for grape arbors

Power washers for cleaning the dairy barn, furrowing houses or poultry house

Machinery used to clear land for future farming (machinery used to construct ponds, roads or make other real property improvements would be taxable)

Rental of farm equipment such as tobacco heaters

Repair items for storage and production facilities (Repair items for any building or structure that is a part of real estate or for bins and tanks used for storage of agricultural products for market, are taxable)

Seeders

Seed stocks and plants

Self feeders and waterers for poultry and livestock

Space heaters for dairy barns for benefit of milking

Signs and safety reflectors attached to farm machinery when passing over public roads

Supplies used in brooder construction and repair (but not applicable to building itself) or sanitation control

Supplies used in incubator repairs or sanitation

Temporary portable fencing material such as metal posts or stakes, strand-wire, and electric fence controllers that will not become a part of real estate

Tillers used in the poultry house to mix litter

Tires, batteries and tubes for tractors and farm machinery

Tires, batteries, tubes and truck covers for unlicensed vehicles used on the farm as well as farm vehicles licensed as such

Tobacco bed covers

Veterinary supplies for poultry or livestock

Welding rods which become a part of farm machinery and equipment

2, 3, 4, and 6 wheelers, golf carts and similar equipment used to herd livestock, gather eggs in a poultry operation, transportation of feed or hay around the farm would be exempt. However, the use of this equipment to go from one field to another to check on crops, general farm transportation, performing maintenance or permanent fence repairs would be taxable. In the case of both exempt and taxable uses of this equipment, the tax may be prorated based on the use.

2. Taxable items - No farmer may claim any agricultural exemption with respect to the purchase of any of the items of tangible personal property listed below:

Air tanks

Antifreeze testers, battery charges

Backhoe attachments for tractors

Bins and tanks for storage of agricultural products for market

Building materials, including lumber, bricks, cement, paint, and nails, for use in building or repairing any building or structure (barn, chicken house, shed, silo, etc.) that is a part of real estate.

Cement mixer operated off a power take-off on farm tractor

Compressors for use in maintenance of equipment

Dog and cat food

Electrical and plumbing supplies and fixtures for the home or any farm tenant building

Fertilizer and liming material for lawn or family garden use

Freezer bags or containers for home use

Fuel oil for heating the home or a farm tenant house changed to fuel oil for farm tenant house (unless paid for by tenant) Fuel oil is exempt for residential heating except for the 1% in some localities

Guns and ammo

Hand tools such as hammers, wrenches, screwdrivers, pliers

Home garden, lawn, or farm shop tools

Lawn mowers hand or powered are taxable (Riding lawn mowers with blade attachments to clean litter from chicken houses, etc, are exempt if that is the exclusive use, otherwise prorate taxable portion)

Lightweight mowers (finishing mowers)

Luxury items which are not agricultural supplies such as radios, tape decks, air conditioning, and other items when bought separately or added to the tractor solely for the benefit or comfort of the farmer are taxable. If, however, these items were part of the tractor when bought new, the items would be exempt (power steering would be exempt if added at a later date)

Oils, lubricants, tires, batteries, tubes, antifreeze, repair parts, or any other items of tangible personal property for use in or on any licensed vehicle (excluding vehicles with farm use tags)

Oxygen, acetylene, and welding equipment used to repair farm machinery and equipment

Permanent fencing material that will become a part of real estate

Post hole digger/auger to erect fence

Power washers for cleaning farm equipment

Protective equipment (example: goggles)

Plants and shrubbery for garden or lawn

Ramps

Rotary tiller for family garden use

Snow blower, blades or other equipment used to clear or maintain roads

Soaps, fly sprays, rat killers and other insecticides or pesticides used on or around the home or farm tenant house

Space heater for shop, etc.

Tire filling units

Twine or rope for home or farm tenant house use

Water pumps and systems for home or a farm tenant house

Weed eaters

Wood saws (see pruning equipment in exempt section)

Work gloves, work clothes and plastic aprons used in a dairy barn or pen to keep clothes clean, also plastic shoe covering for prevention of disease transmission from one poultry house to another

Any other item not used by a farmer in agricultural production for market.

Field Audit Procedures – Sales & Use Tax



Topic: Auctioneers, Agents, Factors

Revised: December 2012

I. References

- A. Code of Virginia:
 - 58.1-602
 - 58.1-603
- B. Virginia Administrative Code:
 - 23 VAC 10-210-140 (Auctioneers)
 - 23 VAC 10-210-1080 (Occasional Sale)
- C. Public Documents:
 - PD 88-335 Auction Conducted by Non-Profit
 - PD 95-294 Public School Fund Raising Auction
 - PD 10-247 Bulk Sales of Storage Units sold via Lien Auction

II. General

- A. Sales of tangible personal property at auctions are taxable. Auctioneers, agents, or factors must collect sales tax on the gross sales price of each taxable sale, even if title to the property being sold rests with another person. "Gross sales price" is the price for which property is sold, without any deduction for commissions, service charges or expenses.
- B. Bulk sales of storage units sold via lien auctions are taxable. This type of auction is initiated to enforce a lien against the rent for the storage unit when the rent becomes delinquent. The storage unit is auctioned off as a whole to enforce the lien. Lien sales do not qualify for the occasional sale exemption, unless they are for the sale of substantially all the assets of a liquidating or reorganizing business.
- C. Exceptions
 - 1. An auctioneer, agent, or factor who sells substantially all the assets of a liquidating or reorganizing business which qualifies as an "occasional sale" is not liable for collection or payment of the tax provided the sale occurs in 3 days or less.
 - 2. An auctioneer is not deemed to be selling at retail if he gratuitously bid calls an auction which is actually conducted by a nonprofit organization, provided the auctioneer has no direct association with the money being collected, registration, clerking, etc.
 - 3. Under very limited circumstances an auctioneer may make sales without collecting the tax such as at a public school fund raising auction, provided the auctioneer has no direct association with the money being collected, registration, clerking, etc.



Field Audit Procedures – Sales & Use Tax

Topic: Audit Techniques

Revised: September 2016

I. References

- A. Code of Virginia:
 - 58.1-633
 - 58-1-618
- B. Public Documents:
 - PD 07-85 (Sampling Methodology)
 - PD 06-146 (Items isolated in nature and not a normal part of business)
 - PD 07-44 (Tax assessment is prima facie evidence)

II. General

This audit procedure addresses five basic issues:

- Research: How to research an audit candidate
- Pre-field Work: What to ask before field work begins
- Field Work: How to use your time wisely
- Post Audit Conference: How to keep it simple
- Sales Closure Letter: What to include

III. Procedures

- A. Research: How to Research an Audit Candidate.
 - 1. Research History in the Department's records.
 - a. Does the candidate have prior audit history?
 - Server Siebel: Query All Cases in Audit Cases or Query in Customers
 - Panagon Report Manager: Use for audit cases closed prior to July 2005.
 - b. Are copies of the prior audits available?
 - Server Siebel: Save the "zip" file attachment to Audit Workbench
 - Archived audits are stored on a secure drive: Files are archived by district and named using a unique format for each district.
 - c. Has the sales and use tax reporting been consistent?
 - Audit Research Tool: The payment record may indicate patterns of reporting, inconsistencies and non filers.

- d. Does the taxpayer have any outstanding bills?
 - AR: Review the bill history
 2. Research the Internet.
 3. What information is provided with the Audit Recommendation?
- B. Pre-field Work: What to Ask Before Field Work Begins
1. What activities is the business involved in? Have the business activities changed since the last audit or during the audit period?
 2. Has there been a change in accounting personnel since the last audit?
 3. Has there been a change in the accounting system since the last audit?
 4. How are the records kept: Electronically or Manually?
 5. What is the volume of records?
 - Electronically: How many records are there and what is the format (example: Excel)
 - Manually: How many boxes/drawers of records in each
 6. Are records available for the entire audit period or for certain periods only?
 7. Should this be a detailed audit or a sampled audit?
 - a. You may detail asset invoices and sample sales and/or purchase invoices
 - Generally, you detail asset invoices
 - Generally ,you sample purchase and/or sales invoices
 - b. Statistical ICT Sample from the population (Your ICT auditor will help you):
 - Must have large volume of records
 - Should have complete and reliable records
 - Should have consistent reporting of returns
 - Should have consistent accounting system
 - Must be able to provide data in an electronic format
 - c. Block Sample from the population:
 - Cannot provide data in electronic format
 - Does not have complete records for the audit period
 - You may find it necessary to expand the block if your examination shows the block is not representative of the population
 - d. Detailed Audit
 - Small volume of records
 - Cannot provide data in electronic format

- Contractor (Request job cost reports & ledgers to limit time spent looking for invoices in vendor files)
8. If you have agreed with the taxpayer to perform a statistically sampled audit, request the following:
 - a. Chart of Accounts - Discuss with the taxpayer what may be included in each account so that you can determine which accounts will be included in the sample
 - b. General Ledger Totals for each account you will be sampling - Reconcile the totals from the information you receive from the taxpayer to the general ledger.
 - c. Data Base Download - The download will include all the accounts you are interested in sampling. Only sample accounts that could have a taxable activity; i.e., you do not want payroll accounts, insurance accounts, etc.
 - d. ICT Auditor - The ICT auditor will use the IDEA software to select a random sample.
 9. If you have agreed to perform a block sample or a detailed audit, you will need to know the following in order to estimate the time to be spent in the field:
 - a. Are asset and capital project invoices filed separately from other invoices?
 - b. How are sales and purchase invoices or other source documents filed?
 - By invoice number?
 - By customer?
 - By month or year?
 - By voucher number?
 - c. Will files be pulled for you or will they be in an easily accessible location?
- C. Field Work: How to Use Your Time Wisely
1. Make sure the records requested are available.
 2. Review the tax returns with the taxpayer to follow the trail used to complete the return.
 3. Stratified Sample Audit Exceptions - Examine the sampled invoices, using an excel spreadsheet.
 4. Block Sample or Detailed Audit:

Examine all invoices in either the block sample or in the detailed audit and enter the exceptions into your audit.

If you or the taxpayer feels an examined block sample does not represent the population, the sample may need to be expanded. Carefully weigh the cost benefit expanding the sample.

5. Asset Invoices: What tools do we use?
 - a. Depreciation Schedule listed by location
 - b. Federal Forms 4562 & 4797
 - c. Capital project files:
 - Assets in Service
 - Assets in Construction-in-Process
 - d. Sales tax returns (with documentation)
 6. Expensed Purchase invoices: What tools do we use?
 - Accounts Payable ledger by location
 - Check register
 - Job List (contractors)
 - Job cost ledgers (contractors)
 - Sales tax returns (with documentation)
 7. Sales invoices: What tools do we use?
 - Sales Journal
 - Shipping Documents
 - Exemption Certificates
 - Sales tax returns (with documentation)
 8. Use your time wisely. Get answers to your questions as they arise. This will eliminate some revisions to the exception list.
 9. When you have completed your invoice examination, leave a copy of the spreadsheet or disk with the taxpayer to review or go over the exception list with the taxpayer.
- D. Post Audit Conference: How to Keep It Simple
1. Review the taxpayer's questions.
 2. Educate the taxpayer about area of non-compliance based on the Code of Virginia, the Administrative Code and PD's.
 3. Review the final list of exceptions.
 4. Explain how and why interest and penalty are computed.
 5. Review the Alternative Method of Calculating the Compliance Ratio for penalty, if appropriate.
 6. Agree or agree to disagree with the final list. If there is no agreement, the audit should be discussed with the audit supervisor and a conference may be held with the taxpayer and the audit supervisor.
- E. Sales Closure Letter:
- Cite references for areas of non-compliance, particularly for contested areas.

Field Audit Procedures – Sales & Use Tax



Topic: Bad Debts

Revised: December 2012

I. References

- A. Code of Virginia:
58.1-621
- B. Virginia Administrative Code:
23 VAC 10-210-160
- C. Public Documents: (Approximately 145 published rulings)
PD 94-153
PD 94-358
PD 94-372
PD 03-16
PD 08-111

II. General

- A. § 58.1-621 of the Code of Virginia provides that a dealer may claim a credit for "the amount of sales or use tax previously returned and paid on accounts which are owed to the dealer and which have been found to be worthless" This section further indicates that amounts "for which a credit has been taken that are thereafter in whole or in part paid to the dealer shall be included in the first return filed after such collection."
- B. No credit may exceed the amount of sales price which is actually uncollectible. Prior payments made to the dealer on a debt which is subsequently determined to be uncollectible must be allocated to the sales price, sales tax and other nontaxable charges based on the percentage that those charges represent to the total debt originally owed to the dealer.
- C. If the dealer receives reimbursement for bad debts from a guarantor for a sale made to a customer, then no bad debt deduction is allowed. A taxable sale does not depend on the source of the reimbursement. See P.D. 94-358 (11/28/94) and P.D. 91-43 (3/19/91).
- D. All amounts recovered through collection efforts must be reported back without any deduction for collection costs incurred. See P.D. 94-372 (12/19/94).

III. Procedures

- A. Verify all deductions for bad debts reported on the sales tax returns. For prior years, the bad debts will be included in deductions on the dealer's federal income tax returns. For current periods, the dealer will have documentation such as a bankruptcy notice supporting amounts deemed worthless.
- B. Once it has been determined that the bad debts are legitimate, the auditor must analyze the amounts deducted to determine if any portion is not

attributable to taxable sales, such as post-sale charges. In order to take the deduction on the sales tax returns, the deduction must be computed on each bad debt, not based on a percentage of sales.

A review of the original document, and payments made, if any, is necessary in order to determine the actual amount of the deduction allowed. For example:

Dealer makes the following sale:

Parts	100.00
Non Taxable repair Labor	35.00
Freight	<u>15.00</u>
Subtotal	\$150.00
Tax	<u>5.00</u>
Total	<u>\$155.00</u>

The customer's current account balance is \$115.00, which reflects a payment at the time of purchase of \$50.00 and finance charges added of \$10.00. The debt is now determined to be uncollectible.

The amount that may be deducted on the sales tax return is \$67.74.

An allocation of the amount previously collected must be computed.

Parts	\$100.00	$100/155.00 \times \$50.00 =$	\$32.26
Labor	35.00	$35/155.00 \times \$50.00 =$	11.29
Freight	<u>15.00</u>	$15/155.00 \times \$50.00 =$	4.84
Subtotal	\$150.00		
Tax (5%)	<u>5.00</u>	$5.0/155.00 \times \$50.00 =$	<u>1.61</u>
Total	<u>\$155.00</u>		<u>\$50.00</u>

Amount of sales price for computing the credit is	\$100.00
	<u>- 32.26</u>
	<u>\$67.74</u>

- C. Analyze any collections of bad debts. These should be reported on the dealer's sales tax returns when recovered. No reduction for costs of collection is allowed.

In the previous example, suppose a collection agency remits a \$50.00 payment to the dealer after the account has been written off and the bad debt deduction has been taken on the sales tax return. The agency actually collected \$55.00 and retained 10% as a collection fee since the dealer did not sell the account.

The dealer would need to report additional sales of \$32.26.

Outstanding debt prior to write-off:

Parts	\$67.74	$67.74/105.00 \times \$50.00$	=	\$32.26
Labor	23.71	$23.71/105.00 \times \$50.00$	=	11.29
Freight	10.16	$10.16/105.00 \times \$50.00$	=	4.84
Tax	<u>3.39</u>	$3.39/105.00 \times \$50.00$	=	<u>1.61</u>
Total	<u>\$105.00</u>			<u>\$50.00</u>

[COMMENTS: Because the finance charge is not part of the original sales price, it cannot be factored into the computation of the bad debt. The \$55.00 payment cannot be used in the computation of the bad debt because the dealer only receives \$50.00 to apply to its worthless account.]

- D. Penalty applies to taxes collected and not remitted. Failure to report subsequent collections of bad debts and to deduct bad debts at the proper amounts, are subject to penalty.

Field Audit Procedures – Sales & Use Tax



Topic: Banks

Revised: December 2012

I. References

- A. Virginia Administrative Code:
 - 23 VAC 10-210-595
 - 23 VAC 10-210-690 (C), (D)
 - 23 VAC 10-210-6010
- B. Legislative Summary:
 - 2011 (Bank Security System Installers Treated as Contractors – 58.1-610 (G))
- C. Public Documents:
 - PD 01-102
 - PD 95-159
 - PD 94-207
 - PD 91-166
 - PD 91-12
 - PD 02-42
- D. Attorney General Opinions:
 - OAG 08091966

II. General

- A. The tax applies to the purchase of tangible personal property by all national, state and local banks, non-federal credit unions, savings and loan associations, and loan and finance companies.
- B. The tax does not apply to purchases of tangible personal property by Federal Credit Unions.
- C. When any bank, non-federal credit union, savings and loan association, or loan and finance company, engages in selling, leasing or renting tangible personal property to consumers, it must register as a dealer and collect and pay the tax to the Department of Taxation.

Taxable sales may include, but are not limited to sales of checks and checkbooks; silverware, savings or piggy banks, repossessed merchandise, gold and silver coins or bars for investment purposes, and charges for the lease or rental of tangible personal property.

The rental of safe deposit boxes are not rentals of tangible personal property and are exempt.

III. Procedures

- A. Pre Audit - Gain a complete understanding of the corporate structure. Banks typically have many separate subsidiaries and divisions. Request a list of all subsidiaries and business operations, and review the corporate income tax

returns for corporate structure. Many banks will have divisions or separate entities performing operations such as: Construction, Property Management, Credit Card, Leasing, etc. Review all applicable records for each operation. The review of the corporate structure will usually raise questions such as:

1. Are all purchases made through a single division or are some divisions responsible for their own purchases? Typically, property or construction divisions will do some of their own purchasing. Some banks have divisions that purchase all the office supplies and invoice the other divisions and branches and charge sales tax.
 2. Has the bank foreclosed on any businesses? Banks often foreclose on businesses (for example, golf courses) and continue the operations. If the bank continues the operation it is responsible for reporting the sales and use taxes for that business.
 3. Does the bank sell assets or other items? Sales to employees of old furniture are common and may be considered occasional sales.
 4. Are there transfers, sales, or leases of assets between related entities? These types of transactions between affiliated businesses are not exempt.
 5. Has the bank sold any branches, divisions, or other operations? The occasional sale exemption may apply in some circumstances.
 6. Does the bank have a leasing division or subsidiary? If so it should be collecting sales tax on all leases of tangible personal property.
- B. Sales – All sales of tangible personal property by national and state banks, non-federal credit unions, savings and loan associations, and loan and finance companies are subject to sales and use tax. Types of sales to be aware of are as follows:
1. Check sales - Banks and credit unions are dealers with respect to the sale of checks and checkbooks to their customers. These entities, or the commercial check printer acting on behalf of the banks, must collect the sales tax on such sales.
 2. Sales of fixed assets - Many banks make a sufficient number of sales of fixed assets to be required to register and collect sales tax. In addition to reviewing individual asset sales, sales of divisions or groups of assets, reorganizations and spin off type sales should be carefully reviewed.
 3. Leases - Banks often have lease departments or subsidiaries. Generally, tax should be collected on the gross proceeds from the rentals of tangible personal property.
 4. Microfilm - In providing checking account services, banks may supply their customers with account information on microfilm, or some other tangible medium. The "true object" test must be applied to these sales.
 5. Resolution Trust Corporation Sales – These sales are subject to sales tax; however, states cannot constitutionally impose a direct tax on the United States government or its instrumentalities. This does not, however, exempt the purchaser of tangible personal property from the use tax.

C. Purchases – Banks are subject to use tax on all purchases of tangible personal property. These businesses purchase a wide array of property and services some of which are specifically tailored to financial institutions. Some types of purchases they typically make are as follows:

1. Checks – Banks are subject to use tax on purchases of checks provided free to their customers.
2. Financial services - Companies that provide banks with financial services such as loan processing, checking account statements, credit authorization services, etc. sometime include in their invoicing, charges for monthly equipment rental. Taxability is determined by the "true object test."
3. Bank Equipment - The auditor must determine if the bank equipment is tangible or real property.

Generally, vault doors, fire doors, visual auto tellers, night depository assemblies, tellerveyors/autoveyors, concrete panel vaults, pneumatic drive-up systems, monitored security systems, and ATM's directly installed in the side of the bank building are real property.

Non-monitored security systems, free-standing ATM's, safe deposit boxes, vault lockers, under-counter teller stations, bullet resistive teller stations, drive-up undercounter, and storage safes remain tangible personal property and are subject to the tax.

Effective July 1, 2011, Code of Virginia § 58.1-610.G provides that businesses primarily engaged in the furnishing and installation of tangible personal property that provides electronic or physical security on real property used by financial institutions shall be deemed a retailer of such property. Such property includes vaults, safe deposit boxes, vault lockers, electronic security systems, digital video systems, card assess systems and similar equipment.

Field Audit Procedures – Sales & Use Tax

Topic: Catalogs & Similar Printed Materials

Revised: September 2016

I. References

- A. Code of Virginia:
 - 58.1-602 (Definition)
 - 58.1-609.6(3) (Publication)
 - 58.1-609.6(4) (Catalogs)
 - 58.1-609.6(5) (Advertising)
 - 58.1-609.10(4) (Interstate Commerce)

- B. Virginia Administrative Code:
 - 23 VAC 10-210-41 (Advertising)
 - 23 VAC 10-210-43 (In-house Advertising)
 - 23 VAC 10-210-780 (Interstate Commerce)
 - 23 VAC 10-210-3010 (Printing)

- C. Public Documents:
 - PD 08-100 Catalog Stands
 - PD 01-202 Catalog and Price List
 - PD 00-123 Similar Printed Materials
 - PD 97-399 Catalog Produced In-House
 - PD 97-248 Virginia Mailing House
 - PD 97-61 Exercise of Right or Power in Direct Mailings
 - PD 96-148 Advertising -Regulations Are Not Retroactive
 - PD 96-63 Interstate Commerce, Constructive Possession
 - PD 95-317 Photo Images Downloaded From Computer Database
 - PD 95-216 Service in Connection With a Sale Is Taxable
 - PD 95-185 Distribution of Catalogs In & Out of Virginia
 - PD 95-112 Form ST10A & Estimated Percentages
 - PD 94-294 Interstate Commerce
 - PD 94-266 "Use" in Virginia
 - PD 94-248 CD-ROM Exempt
 - PD 94-239 Swatch Cards Not Printed Material
 - PD 93-217 Constructive Possession
 - PD 93-162 Administrative Supplies
 - PD 92-112 Labels
 - PD 91-30 Videotape Not Printed Material
 - PD 91-26 Advertising Rules - Old
 - PD 90-220 Postage Exempt When Separately Stated
 - PD 90-218 Labels Taxable
 - PD 89-99 Transactions In & Out of Virginia
 - PD 87-243 Estimating Taxable Percentages

PD 87-200 Interstate Commerce
PD 86-103 Interstate Commerce
PD 86-9 Service in Connection With a Sale Is Taxable

D. Exemption Certificate:
ST-10A

II. Definitions

The following words or terms are useful in understanding the catalog statute:

- A. **"Administrative supplies"** as defined in Code of Virginia § 58.1-609.6(4) "includes, but is not limited to, letterhead, envelopes, and other stationery; and invoices, billing forms, payroll forms, price lists, time cards, computer cards, and similar supplies. This definition is expanded in the catalogs and other printed materials regulation to include, but not limited to "... certificates, business cards, diplomas, and awards. The term also includes supplies for internal use by the purchaser, such as menus, calendars, datebooks, desk reminders, appointment books, and employee newsletters." The printing regulation also includes "other house organs." But even administrative supplies may be exempt when they become an integral part of exempt printed materials. The printing regulation in paragraph H states that "... letterhead upon which fundraising or promotional letters are printed, return envelopes enclosed with fundraising letters, and price lists enclosed within catalogs advertising tangible personal property for sale or resale are not taxable." (See PDs 01-202 and 93-162.
- B. **"Advertising"** as defined in Code of Virginia § 58.1-602 "... means the planning, creating, or placing of advertising in newspapers, magazines, billboards, broadcasting and other media, including without limitation, the providing of concept, writing, graphic design, mechanical art, photography and production supervision. Any person providing advertising as defined herein shall be deemed to be the user or consumer of all tangible personal property purchased for use is such advertising."
- C. **"Advertising business"** as defined in the advertising regulation "... means any person or group of persons providing 'advertising' ..."
- D. **"Similar printed materials"** means printed materials used for promotional purposes, except administrative supplies." Examples of similar printed materials are:
- Fund raising and promotional letters, circulars, folders, brochures, and pamphlets, including those for charitable, political, and religious purposes;
 - Corporate stockholder meeting notices;
 - Proxy materials and enclosed proxy cards;
 - Meeting and convention promotional materials;
 - A business prospectus;
 - Corporate monthly, quarterly, and annual stockholder reports:

- Announcements, invitations, and informational pieces for external promotional purposes;
- Greeting cards, brochures, menus, calendars, datebooks, desk reminders, appointment books, art prints, and posters for external promotional purposes; and
- Printed point-of-purchase sales devices, including display racks, animated and action pieces, posters and banners.

E. **"A sale in interstate commerce"** as explained in the interstate and foreign commerce regulation means "a sale... when title or possession to the property being sold passes to the purchaser outside of Virginia and no use of the property is made within Virginia." 23 VAC 10-210-780 provides four examples to which the tax does not apply. Further clarification can be found in PDs 86-103, 87-200, 93-217, 94-266, 94-294, and 96-63.

III. General

A. Code of Virginia § 58.1-609.6(4) provides an exemption for:

Catalogs, letters, brochures, reports, and similar printed materials, except administrative supplies, the envelopes, containers and labels used for packaging and mailing same, and paper furnished to a printer for fabrication into such printed materials, when stored for twelve months or less in the Commonwealth and distributed for use without the Commonwealth.

The statute defines "administrative supplies." (See Section II.A) The statute is actually straightforward and relatively easy to interpret except that the advertising statute and regulations specifically tax advertising businesses on these types of purchases. (See Section IV) Effective 7/1/94, the statute was expanded so that Virginia printing and direct mail houses would not be put at a competitive disadvantage when dealing with out-of-state advertising businesses. The statute continues:

Notwithstanding the provisions of subdivision 5 [the advertising exemption] of this section or the definition of "advertising" contained in § 58.1-602, (i) any advertising business located outside the Commonwealth which purchases printing from a printer within the Commonwealth shall not be deemed the user or consumer of the printed materials when such purchases would have been exempt under this subdivision....

Another legislative change effective 7/1/95 put Virginia advertising businesses on parity with all other companies **when making purchases from a Virginia printer**. This, in effect, has given a competitive advantage to Virginia printers since the exemption is limited to purchases from an in-state printer. Any printing purchased from an out-of-state printer is 100% taxable when constructive delivery takes place in Virginia (i.e., a Virginia mailing house) or if delivery is made to the purchaser's Virginia location, regardless of its eventual distribution.

... and (ii) from July 1, 1995 through June 30, 2002, and beginning July 1, 2002 and ending July 1, 2017, any advertising business which purchases printing from a printer within the Commonwealth shall not be deemed the user or consumer of the printed materials

when such purchases would have been exempt under subdivision 3 [newspaper/magazine exemption] or this subdivision, provided that the advertising agency shall certify to the Tax Commissioner, upon request, that such printed material was distributed outside the Commonwealth and such certification shall be retained as a part of the transaction record and shall be subject to further review by the Tax Commissioner.

Note the unusual wording of this section that states the Commissioner can request certification that the printed material was actually distributed outside Virginia.

IV. Procedures

Transactions discussed in these procedures are from the viewpoint of the purchaser. It is assumed that all examples meet the limitations set out in § 58.1-609.6(4) for catalogs and similar printed materials and occur under current law unless otherwise stated. The examples deal strictly with the application of the Virginia sales tax law to catalogs and similar printed materials. Furthermore, the terms "taxable" and "exempt" are also limited to Virginia sales tax - another state's tax may well apply. Except for the procedures discussed in section D, all transactions should be considered purchased by other than an advertising business. Finally, delivery, whether actual or constructive, is often the crucial criteria that will determine the taxability of catalogs and similar printed materials.

The treatment of sales by the seller can readily be inferred from the purchase scenarios, but will not be specifically addressed. If catalogs and similar printed materials are sold **for resale** (to other than advertising businesses), the purchaser can provide a Form ST-10 to purchase such resale materials exempt, whether or not they meet the provisions of § 58.1-609.6(4).

A. Purchases:

When auditing a business which has purchased catalogs, etc., it is important for the auditor to answer five questions - **who, what, where, when, and how**. Each question is important and can turn an otherwise exempt transaction into a taxable situation. Strict construction is the rule.

- Who is purchasing the materials in question? (Is it an advertiser or non-advertiser?)
- What is being purchased? (Does it qualify for exemption under the definitions?)
- Where is it being distributed from and where is it going? (Location is important.)
- When is it leaving the state? (Storage in Virginia has to be twelve months or less.)
- How is the distribution made? (Is it interstate commerce or not?)

1. Printing, Mailing Services and Catalogs, Etc.

- a. When separately stated, postage is exempt from the sales tax.
(See PD 90-220)

- b. Mailing services (i.e., folding, stapling, stuffing, delivery to the post office) are ordinarily not taxable. However, when the services include the provision of tangible personal property, the entire charge becomes taxable. The printing of non-customized mailing labels by a mailing service which are then placed on the materials provided by the customer makes all service charges taxable except separately stated postage or delivery. Printing the materials that the customer wants mailed or distributed will also make such services taxable. The exemption for catalogs, etc. is explained below (See PDs 86-9, 90-218, 92-112, and 95-216)
- c. The Code provides an exemption from the sales tax for catalogs, letters, brochures, reports, and similar printed materials (**except administrative supplies**), the envelopes, containers and labels used for packaging and mailing the same and paper furnished to a printer for fabrication into such printed materials, when stored for twelve months or less in Virginia and distributed for use outside Virginia. (Review the Section II for definitions of "similar printed materials" and "administrative supplies".) If these conditions are met, and Form ST-10A is provided to the mailing service or printer, there is no sales tax liability.

Although the condition that the materials be used for advertising the sale of tangible personal property is no longer stated in the Code, public documents have consistently ruled that the printed materials must still be promotional or informational in nature to qualify for exemption.

2. Use of Form ST-10A:

By providing Form ST-10A to the vendor, the customer may purchase exempt all catalogs that are stored for twelve months or less in the state and distributed outside of Virginia. If the customer knows which items are taxable at the time of purchase, sales tax may be paid to the printer/ mailing service or consumer use tax may be accrued and remitted directly to the state. If it is unknown how the catalogs will be distributed, the customer may submit Form ST-10A to the vendor, purchase all catalogs exempt and remit consumer use tax on those delivered in the state or stored in the state for more than 12 months. If it is impractical to determine exact numbers, an estimated percentage of Virginia delivered catalogs may be used. Printing for the customer's own use or consumption within Virginia and storage in the state for longer than twelve months should be taken into consideration when determining percentages. (See PDs 87-243 and 95-112)

3. CD-ROMs, Videotapes, Swatch Cards & Pictures - Printed Material?

Catalogs on CD-ROM are treated as printed material while instructional videotapes are not. Swatch cards (material swatches attached to cards with descriptive print) are not printed material, but a furniture company's finished pictures of furniture lines with specifications are. (See PDs 94-248, 91-30, and 94-239)

4. In-house Advertising Department

An in-house advertising department is only an advertising business when performing out-of-house jobs. Therefore the general exemption is available for in-house work that meets the definition of catalogs, etc., is stored in Virginia 12 months or less, and is distributed for use outside of Virginia. (See PD 97-399)

B. Transactions that Occur Within Virginia (Except Advertising Businesses)

There are several types of transactions concerning the distribution of materials defined in the catalog section and meeting the time limitation that can occur within Virginia. These refer to the taxability of the purchase or production of catalogs, etc.

1. Virginia business distributing from their Virginia location:

- Delivered through interstate commerce out of state: EXEMPT
- Delivered in Virginia: TAXABLE

2. Virginia business using Virginia printer and/or Virginia mailing company:

- Delivered through interstate commerce out of state: EXEMPT
- Delivered in Virginia: TAXABLE

3. Virginia business using out-of-state printer and a Virginia mailing company:

- Delivered through interstate commerce out of state: EXEMPT
- Delivered in Virginia: TAXABLE

4. Out-of-state business using Virginia printer and/or Virginia mailing company:

- Delivered through interstate commerce out of state: EXEMPT
- Delivered in Virginia: TAXABLE

5. Out-of-state business using an out-of-state printer and a Virginia mailing company:

- Delivered through interstate commerce out of state: EXEMPT
- Delivered in Virginia: TAXABLE

(See PDs 89-99, 95-185 and 97-248)

C. Transactions that Occur Outside Virginia (Except Advertising Businesses)

There are several types of transactions concerning the distribution of materials defined in the catalog section and meeting the time limitation which occur outside Virginia. Following are scenarios which refer to the taxability of the purchase or production of catalogs, etc., **and delivered to other than the purchaser's business.**

1. Virginia business using out-of-state printer and/or mailing company:
 - Remaining out of state EXEMPT
 - Delivered in Virginia EXEMPT*
2. Virginia business using a Virginia printer and an out-of-state mailing company:
 - Remaining out of state EXEMPT
 - Delivered in Virginia EXEMPT*
3. Out-of-state business using out-of-state printer and/or mailing company
 - Remaining out of state EXEMPT
 - Delivered in Virginia EXEMPT*
4. Out-of-state business using a Virginia printer and an out-of-state mailing company:
 - Remaining out of state EXEMPT
 - Delivered in Virginia EXEMPT*

***NOTE:** Even though the catalogs are being delivered into Virginia, the purchaser has exercised no right or power over them in Virginia. (See PDs 95-185 and 97-61)

D. Advertising Businesses

Under the statutory definition of advertising, an advertising business is a service provider and is considered "to be the user or consumer of all tangible personal property purchased for use in such advertising." Because of this specific language, prior to the 1994 and 1995 statute amendments all advertising businesses were precluded from taking advantage of the catalog exemption. Consequently, all purchases of printing by an advertising business were taxable.

Effective 7/1/94 the statute was expanded to allow any advertising business located outside Virginia to purchase printing exempt from a **Virginia printer** as long as the printing met the definition and limitations for catalogs, etc. Then, effective 7/1/95 the catalog exemption as well as printed materials exemption under § 58.1-609.6(3) (the newspaper exemption) was extended to Virginia advertising businesses when the printed material is purchased from a **Virginia printer**. These printed materials, likewise, have to be stored in Virginia for 12 months or less and distributed for use outside the state. The 1995 amendment currently has an expiration date of 6/30/17. Purchases by a Virginia advertising business from an out-of-state printer remain 100% taxable when the printing is delivered to the advertising business in Virginia or to a Virginia mailing house, regardless of its eventual distribution. (See PD 96-148) The following examples reflect current law.

1. Out-of-state advertising business using Virginia printer:
 - Delivered through interstate commerce out of state: EXEMPT
 - Delivered in Virginia: TAXABLE

- | | |
|--|---------|
| 2. Virginia advertising business using Virginia printer: | |
| • Delivered through interstate commerce out of state: | EXEMPT |
| • Delivered in Virginia: | TAXABLE |
| 3. Out-of-state advertising business using out-of-state printer: | |
| • Remaining out of state: | EXEMPT |
| • Delivered in Virginia: | EXEMPT |
| 4. Virginia advertising business using out-of-state printer: | |
| • Remaining out of state: | EXEMPT |
| • Delivered in Virginia: | TAXABLE |

Field Audit Procedures – Sales & Use Tax



Topic: Exemption Certificates

Revised: December 2012

I. References

- A. Code of Virginia:
58.1-623
- B. Virginia Administrative Code:
23 VAC 10-210-280
- C. Public Documents:
PD 00-91
PD 05-82
PD 07-68
PD 08-9
PD 08-18
PD 09-92
PD 09-152
PD 11-128

II. Certificates

ST-10 Sales and Use Tax Certificate of Exemption

Often referred to as a "Resale Certificate". Used by dealers for the exempt purchase of items for resale or lease.

Multi-State/Blanket Resale Exemption Certificates (PD 08-18). The use of such certificates is limited to the stipulations presented in P.D.'s 95-303, 95-316, and 97-039, related to the use of a resale exemption certificate. The multi-state or blanket resale exemption certificate must mirror the information required on the Virginia Form ST-10. Otherwise an out-of-state customer that is not purchasing for resale must use the applicable Virginia exemption certificates.

ST-10A Printed Materials

Multipurpose certificate used by purchasers of catalogs and similar printed materials for temporary storage in the Commonwealth of Virginia, by purchasers delivering goods to a factor or export agent, by purchasers of advertising supplements, and by purchasers of advertising.

ST-10B Handicap Auto Equipment

Used by handicapped persons for the purchase of special equipment for installation on a motor vehicle.

ST-11 Manufacturing

Multipurpose certificate used by manufacturers, miners, printers and other industrial processors. Certified pollution control equipment as well as property qualifying for the research and development exemption may also be purchased exempt using this certificate.

ST-11A Contractors

Used by contractors and non-manufacturers for the specific purpose noted on the certificate.

ST-12 Government

Used by Virginia, political subdivisions of Virginia, and the United States government. This certificate is not valid for use by states other than Virginia, political subdivisions of those states, or national governments other than the United States.

ST-13 Medical-Related Exemptions

Used for specific medical-related exemptions.

ST-13A Churches

Used by non-profit churches. Non profit churches also have the option of applying for a numbered exemption certificate with a broader exemption.

ST-14 Out of State Resale Dealer

Exclusively used by Out-of-State-Dealers who purchase property in Virginia for immediate transportation out of Virginia for resale outside the state. This is not a "blanket" certificate in the way that an ST-10 is a blanket certificate. A separate ST-14 is required for each sale.

ST-14A Out of State Livestock Dealer

Used by Out-of-State dealers or brokers who purchase livestock in Virginia for immediate transportation out of Virginia for resale. Unlike the ST-14, this is a "blanket" certificate and the selling livestock dealer need have only one properly executed certificate on file for the out-of-state dealer or broker.

ST-15 Domestic Fuel

Used by Individuals to purchase heating oil, propane, firewood, or coal for domestic consumption exempt of the state sales tax. The local tax may continue to be charged, depending on whether the specific locality in which fuel dealer is located has adopted an ordinance specifically exempting fuels purchased by individuals for domestic consumption.

ST-16 Commercial Watermen

Used by watermen who extract fish, bivalves, or crustaceans from waters for commercial purposes.

ST-17 Forest Harvesters

Used by harvesters of forest products.

ST-18 Farmer's Purchase of Personal Property

Used by farmers for the purchase of property used in producing agricultural products for market.

ST-19 Shipping Commerce

Multipurpose certificate used by shipping (as in boat) lines engaged in interstate or foreign commerce, ship builders, companies engaged in building, converting, or repairing ships or vessels used or to be used in interstate or foreign commerce.

ST-20 Public Service Corporation

Used by certain public service corporations, commercial radio and television companies, motion picture theatres, cable television systems, certain airlines, and taxicab operators.

Effective September 1, 2004, the retail sales and use tax exemption available to public service corporations for the purchase or lease of tangible personal property used or consumed directly in the rendition of their public service was repealed. Those public service corporations losing their exemption include electric suppliers, telecommunications companies, certain telephone companies, gas, water and sewer utilities and motor vehicle common carriers. Common carriers of property or passengers by railway did not lose their exemption. In addition, to the extent public service corporations, generating electric power, qualify for the manufacturing exemption under Code of Virginia § 58.1-609.3(2), they will be prohibited from claiming the manufacturing exemption, except for raw materials that are consumed in the production of electricity, including fuel. (See PD 04-122)

ST-20A Production Company

Used by production companies, program producers, radio, television and cable TV companies, and other entities engaged in the production and creation of exempt audiovisual works and the licensing, distribution, and broadcast of the same.

ST-22 Railroad Rolling Stock

Used to purchase railroad rolling stock (freight cars, etc.) from a manufacturer.

ST-23 Multi-fuel Heating Stoves

Used by an individual purchasing a multi-fuel heating stove for heating their personal residence. This exemption is effective from 7/1/07 through 6/30/12. (See Code of Virginia §58.1-609.10 18 and Public Document 08-179)

ST-24 Fabrication of Foodstuffs

Used for purchasing the fabrication of foodstuffs. (See Virginia Tax Bulletin 09-7, PD 09-92 (6/9/09)).

Numbered Exemption Certificates issued by the Department

On July 1, 2000, the Virginia Department of Taxation began to issue numbered exemption certificates to nonprofit organizations which had previously been granted an exemption and had met certain informational filing requirements. Effective July 1, 2004, all Internal Revenue Code (IRC) § 501(c)(3) and charitable § 501(c)(4) organizations can qualify for a sales and use tax exemption if they meet certain eligibility criteria.

III. General

- A. A dealer is to collect sales tax on other wise taxable transactions, unless a valid exemption certificate is accepted from the purchaser.
- B. The dealer must act in good faith and exercise reasonable care and judgment to prevent the receiving of a false, fraudulent or bad faith exemption certificate.
- C. A certificate that is incomplete, invalid, infirm or inconsistent on its face is never acceptable.

IV. Procedures

- A. If the taxpayer's exemption certificates are incomplete, allow sufficient time (thirty days maximum is suggested) to obtain the certificates from his customers.
- B. Certificates secured by a taxpayer at the conclusion of an audit are more closely scrutinized because the taxpayer did not rely on such certificate at the time of sale. Once an exemption certificate is presented to the auditor, the certificate is acceptable only if the Department is able to confirm that the customer's use of the certificate was valid and proper for the specific transaction. The absence of such certificate at the moment of the transaction indicates that such certificate was never accepted "in good faith." PD 98-29 sets out the Department's policy with regard to this issue.
- C. Incomplete certificates, i.e., certificates lacking any of the following are invalid:
 - 1. Date
 - 2. Signature
 - 3. Indication of use (box checked)
 - 4. Registration number where required
 - 5. Names and addresses of the supplier and the customer
- D. The purchase made and the manner in which it is made must be consistent with the language of the exemption certificate. For example, an ST-10 prohibits use by a contractor, and an ST-12 indicates that an official purchase order is required. Note: In 2009, the Department was involved in a court case in the Circuit Court of Fairfax County, International Paper Company d/b/a Xpedx v. Commonwealth of Virginia, Department of Taxation. Case # CL-2009-360. This Court held that a dealer can satisfy its burden of good faith and reasonable care and judgment in taking a certificate to the effect that the property purchased is exempt if: Upon a facial examination of the certificate, a dealer could reasonably conclude that the items purchased could potentially be used for any of the exempt purposes claimed on the certificate of exemption; or
- E. Based upon the actual dealer's knowledge of the business of its purchaser, the dealer could reasonably determine in good faith that the specific purchaser intended to use the items purchased for one or more of the exempt purposes claimed on the certificate of exemption. First generation audits are considered an opportunity to educate the taxpayer. Where a properly executed exemption certificate is on file, it should be honored. Properly executed certificates that subsequent events (Repeal of Exemption) have made invalid should be revoked. The taxpayer should be instructed as to what items are not included in the exemption or what laws have recently changed. The audit comments should contain a summary of the items discussed in this area.



Field Audit Procedures – Sales & Use Tax

Topic: Certificate of Registration

Revised: December 2012

I. References

- A. Code of Virginia:
58.1-613
- B. Virginia Administrative Code:
23 VAC 10-210-290
- C. Applicable Forms:
Form R-1 Business Registration Application
R-1 Instructions
R-3 Registration Change Request
- D. Additional References:
Users Guide for Registration Procedures & Business Registration Guide

II. General

- A. The Virginia Retail Sales and Use Tax Act requires every individual, partnership, corporation, etc. desiring to engage in or conduct business as a dealer to apply for a certificate of registration. (See 23 VAC 10-210-460 for the definition of a dealer.)
- B. Out of state dealers who do not have the obligation to obtain a registration can voluntarily do so for the benefit of their customers.

III. Procedures

- A. Determine the business entity type (sole proprietorship, general partnership, limited partnership, corporation, etc.). Refer to the Business Registration Guide for definitions of entities.
- B. Complete and submit Form R-1. Persons or Corporations wishing to do business in the Commonwealth of Virginia have the option of either registering on-line at: <https://www.ireg.tax.virginia.gov/VTOL/Login.seam>. Or they can register using the downloadable form R-1. This form can be used to apply for most Virginia taxes; however, for the sales and use tax, a separate application is required for each location.

The certificate of registration must be displayed at the location of the business.
- C. A new certificate of registration is required if a business changes its entity type. The following are examples of changes that require an application for a new certificate of registration:
 - Sole proprietorship becomes a corporation or a partnership.
 - Corporation becomes a sole proprietorship or a partnership.

- Partnership becomes a sole proprietorship or a corporation.
 - Partnership no longer has any of the partners listed on the original certificate of registration application.
- D. Should the business cease to exist, the certificate of registration expires and should be returned to the Department.

Field Audit Procedures – Sales & Use Tax



Topic: Churches

Revised: December 2012

I. References

- A. Code of Virginia:
 - 58.1-609.10(16)
 - 58.1-609.11
 - 58.1-609.6(6)
- B. Virginia Administrative Code:
 - 23 VAC 10-210-310
- C. Legislative Summaries: 2007, 2005, 2004, 2003, 1999, 1995, and 1986
- D. Virginia Tax Bulletins:
 - VTB 05-4
 - VTB 99-9
 - VTB 87-4
 - VTB 86-8
 - VTB 83-12
- E. Public Documents:
 - PD 05-9 Worship Service and Church Building
 - PD 97-107 Effect of HB 1562 of 1997 General Assembly
 - PD 96-196 Sales of food by churches
 - PD 95-115 Denominational Governing Body
 - PD 95-54 Automotive Parts
 - PD 94-237 Christian Ministry Camp
 - PD 94-11 Church Affiliated Day Care Center
 - PD 93-204 Church Operated Swimming Pool
 - PD 93-177 Campground Facilities
 - PD 91-157 Roman Catholic Church: Education Programs-Marriage
 - PD 92-55 Property Purchased By Churches-Conference Center
 - PD 90-164 Administrative Governing Body (see also PD 95-115)
 - PD 90-66 Mobile Food Bank-Church Parking Lots
 - PD 90-36 Building Materials
 - PD 89-331 Food for Distribution
 - PD 89-176 Camp Meeting
 - PD 89-174 Rentals: Church Christmas Play
 - PD 88-216 Items Used in Public Church Buildings
 - PD 88-85 Church Provided Prison Ministry
 - PD 88-14 Conference Center
 - PD 87-65 Meals Sold at Cost By Church
 - PD 86-109 Non Profit Religious Shelter
 - PD 08-181 Building Materials Installed By Others
 - PD 10-4 Building Materials Installed By Others
 - PD 10-188 Fuel purchased for use and consumption by churches

- F. Exemption Certificates:
ST13-A or numbered exemption certificate issued by the Department.

II. General

- A. Under the traditional church exemption, a church enjoys a limited exemption from the tax on purchases of tangible personal property used in carrying out the work of the church or churches. Code of Virginia § 58.1609.10(16) states that a church is exempt from tax on the purchases of tangible personal property if the church is conducted not for profit and exempt under IRC 501 (c) (3), or exempt from local taxation on real property pursuant to Code of Virginia § 58.1-3606.
- B. If a church applies for and receives a numbered exemption certificate as a nonprofit entity under Code § 58.1-609.11, it receives a broader exemption than the traditional church exemption. The limitations of the church exemption contained in § 58.1-609.10(16) do not apply. As a qualifying nonprofit entity, there is no restriction on the types of tangible personal property that may be purchased exempt. Taxable services are still taxable, however.
- C. Neither exemption applies to churches operating for profit.

III. Procedures – Traditional Church Exemption (ST-13A)

- A. Exempt Purchases by Churches:

In order to qualify for the exemption, items must be purchased by, invoiced to, and paid for directly by the church. Purchases made on behalf of the church, even if reimbursed by the church, are subject to the tax.

The exemption applies to purchases of the following tangible personal property (an exemplary list can be found in 23 VAC 10-210-310):

1. For use in religious worship services by a congregation or church membership while meeting together in a single location.
2. For use in the libraries, offices, meeting or counseling rooms or other rooms in the public church buildings used in carrying out the work of the church and its related ministries, including kindergarten, elementary and secondary schools.
3. Baptisteries, bulletins, programs, newspapers and newsletters which do not contain paid advertising and are used in carrying out the work of the church.
4. Gifts, including food, for distribution outside the public church building.
5. Food, disposable serving items, cleaning supplies and teaching materials used in the operation of camps or conference centers by the church or an organization composed of exempt churches and which are used in carrying out the work of the church or churches.
6. For use in caring for or maintaining property owned by the church including, but not limited to, mowing equipment, and building materials

installed by the church and for which the church does not contract with a person or entity to have installed, in the public church buildings used in carrying out the work of the church and its related ministries, including, but not limited to worship services; administrative rooms; and kindergarten, elementary, and secondary schools.

B. Taxable Purchases:

1. Tangible personal property purchased by a church is generally taxable when it is (i) not used in religious worship services by a congregation or church membership while meeting in a single location; (ii) not used in sanctuaries, libraries, offices, meeting or counseling rooms, or other rooms in the public church buildings used in carrying out the work of the church and its related ministries; or (iii) used by separate legal or business entities that may be associated with the church.

2. Construction and building materials furnished to contractors.

If building materials, kitchen equipment, heating and air conditioning equipment, tool sheds, and picnic shelters are furnished by the church to a contractor for incorporation in real estate, and the church did not pay the tax on the materials, the contractor, as the user and consumer of the materials, must pay the use tax directly to the department based on the fair market value of the materials used, irrespective of whether or not any right, title, or interest in the materials become vested in the contractor. However, a baptistry that will be incorporated into real estate at the public church building and used in the religious services of a church is exempt from the tax whether purchased by the church or the contractor.

3. Examples of other taxable purchases include any property used on church trips, picnics, or similar outings outside a public church building; or bulletins, programs, newspapers, and newsletters that contain paid advertising (including paper and ink used in printing).

C. Sales:

1. Churches that make retail sales of tangible personal property are required to register as dealers, collect the tax from customers (who may include church members, visitors, or other persons outside the church membership) and remit the tax to the department.
2. If a church makes sales of food for which a profit is realized, the church should collect sales tax. In these instances, the church may purchase the food exempt from the tax using a resale exemption certificate. For purposes of this subdivision only, if the sales price charged for food is completely offset by the cost of the food, and the church realizes no profit, then the church is not required to charge the tax to its customers on the sales price of the food. Instead, the church must pay the tax to its vendors on the purchase price of the food purchased. As long as the church pays tax on the purchase price of the food that it sells at cost, the church is not required to register as a dealer while conducting this activity or charge tax to customers.

3. If a church makes sales of cassette tapes, audiovisual tapes, books, photo directories, and jewelry or makes sales of tangible personal property in yard sales or bazaars, the church should register as a dealer, collect the tax from its customers and remit the tax to the department.
4. Occasional sales. Except as provided in (2) above, the church must collect the tax on all sales and remit the amount to the department unless the sales meet the criteria for occasional sales. Yard sales and bazaars do qualify as occasional sales.

D. Camps and Conference Centers:

1. Church-related activities.

a. Purchases. The tax does not apply to purchases of food and beverages, disposable serving items (such as paper plates, cups, napkins, plastic forks, spoons, and knives), cleaning supplies, and teaching materials used and consumed in operating camps or conference centers by a church or an organization composed of churches that are exempt from the sales and use tax and that are used in carrying out the work of the church and its related ministries

b. Sales.

- i. Rooms, lodgings, and accommodations. When a church or organization composed of churches operates a camp or conference center and makes separate charges for room rentals, lodging, and accommodations, the charges are taxable. Tangible personal property used and consumed in providing rooms, lodging, and accommodations is taxable at the time of purchase.
- ii. Meals. When a church or organization composed of churches operates a camp or conference center and sells meals to participants, the sales price of meals are taxable. However, the food provided in the meals, as well as paper placemats, plastic silverware, and similar items furnished with the meals and disposed of after the use by only one person, may be purchased exempt of tax under a resale exemption certificate.
- iii. Camp fees. When a church or organization composed of churches operates a camp and charges the participants a camp fee that covers expenses incurred to provide meals, lodging, and camp activities, the camp fee is tax exempt. Further, the church or organization carrying out the work of the ministry may purchase the items described under purchases above exempt from the tax.

2. Nonchurch-related activities. When food, disposable serving items, teaching materials, or cleaning supplies are purchased by a church or organization of churches for use in camps and conference centers for nonchurch-related activities, they are subject to the sales and use tax in the same manner of other providers of meals and accommodations. Nonchurch-related activities would include, but are not limited to, the renting of the facility for

conferences, retreats, etc., by businesses, business groups, governmental organizations, and civic groups.

- E. A church is exempt from the use tax on donations of tangible personal property that it receives from individuals, businesses, and other organizations. Persons making such donations are liable for the tax not previously paid on the cost price of the donated items unless those items are withdrawn from inventory, as provided in subdivision 15 of Code of Virginia § 58.1-609.10, or otherwise exempt from the tax.
- F. Affiliated organizations: Tangible personal property purchased by affiliated religious associations or corporations, such as political action committees (PACs) and separately organized broadcasting ministries, is taxable.

IV. Procedures - Nonprofit Entity - Numbered Exemption Certificate

Under Code of Virginia § 58.1-609.11, a church that files an application with the Department and meets the applicable criteria will be issued a numbered exemption certificate. This certificate confirms that the church qualifies for the nonprofit exemption, and has both an issued date and an expiration date. Under this exemption the church may purchase all tangible personal property exempt. The exemption does not extend to the purchase of taxable services, such as meals or lodging.

Sales by this type of nonprofit entity, sufficient in number to exceed those allowed for an occasional sale, are taxable.



Field Audit Procedures – Sales & Use Tax

Topic: Overcollection and Erroneous Collection

Revised: December 2012

I. References

- A. Code of Virginia:
 - 58.1-625 (Collection of tax)
 - 58.1-16 (Overcollection of tax)
- B. Virginia Administrative Code:
 - 23 VAC 10-210-340 (Collection of tax by dealers)
- C. Public Documents:
 - PD 94-80
 - PD 97-316
 - PD 99-60
 - PD 08-106

II. General

All sales and use tax collected by the dealer must be remitted to the Virginia Department of Taxation. This includes over collected taxes, tax collected on nontaxable transactions, and collection of the wrong state's tax on Virginia transactions.

III. Procedures

- A. Any dealer collecting the sales and use tax on nontaxable transactions must remit the sales tax to the Department unless he can show that the tax has been refunded to the customer. Such nontaxable transactions include exempt sales and out-of-state sales.
- B. Any dealer who over collects the tax must remit any amount over collected to the state. This includes wrong state's tax collected on Virginia transactions.
- C. Compare tax collected to tax reported.



Field Audit Procedures – Sales & Use Tax

Topic: Contractors

Revised: December 2012

I. References

- A. Code of Virginia:
 - 58.1-610 (Contractors)
 - 58.1-609.1(4) (Governmental and Commodities Exemptions)
 - 58.1-609.2(1) (Agricultural Exemptions)
 - 58.1-609.3 (Commercial and Industrial Exemptions)
 - 58.1-609.6(2) (Media Related Exemptions)
- B. Virginia Administrative Code:
 - 23 VAC 10-210-410 (Contractors Respecting Real Estate)
- C. Virginia Tax Bulletin:
 - VTB 92-2 (Public School Equipment)
- D. Public Documents:

PD 88-115	PD 90-210	PD 91-50
PD 92-29	PD 93-23	PD 93-88
PD 93-91	PD 94-104	PD 94-195
PD 94-207	PD 94-334	PD 95-32
PD 95-62	PD 95-154	PD 95-204
PD 95-260	PD 95-295	PD 96-4
PD 96-24	PD 96-28	PD 94-298
PD 97-119	PD 97-156	PD 97-464
PD 97-491	PD 98-28	PD 98-34
PD 98-36	PD 98-139	PD 98-145
PD 99-118	PD 01-60	PD 03-87
PD 04-202	PD 05-159	PD 06-50
PD 07-108	PD 08-98	PD 08-154
PD 09-15	PD 09-35	PD 09-102
PD 09-113	PD 09-142	PD 09-150
PD 09-154	PD10-20	PD 10-177
- E. Exemption Certificate:
 - ST-11A (Limited to certain classifications of jobs).
 - The contractor must make application to the Virginia Department of Taxation, furnishing the name, address, location or premises where the property is to be installed, and the projected completion date of the project, along with a complete description of the property to be installed. Once the information has been reviewed and approved, the contractor will be provided with the appropriate restricted exemption certificate to use in making the purchases for the project tax exempt.

II. General

- A. Generally. Unless otherwise noted, the law treats every contractor as the user or consumer of all tangible personal property furnished to him or by him in connection with real property construction, reconstruction, installation, repair, and similar contracts. A contractor, whether a prime contractor or a subcontractor, does not pass the sales or use tax on to anyone else as a tax. He takes the amount of tax paid in consideration when submitting bids.
- B. Exemption Certificates. Contractors may use form ST-11A to purchase tax exempt materials used in the performance of the following contracts:
1. Machinery or component parts thereof used directly in manufacturing, processing, refining, mining or conversion of products for sale or resale.
 2. Items used directly in the drilling or extraction of natural gas or oil for sale or resale and in well area reclamation activities required by federal or state law.
 3. Tangible personal property used by a public service corporation engaged in business as a railway common carrier directly in the rendition of its public service.
 4. Broadcasting equipment and parts and accessories thereto and towers used by radio and television stations and cable television systems.
 5. Tangible personal property purchased for use or consumption directly and exclusively in basic research or research and development in the experimental or laboratory sense. **Tangible property incorporated into real property is not exempt from the tax.**
 6. Tangible personal property incorporated into real property in another state or foreign country, which could be purchased free from the tax in such state or foreign country. **Equipment, tools, etc. used in the performance of the construction project are not exempt from the tax.**
 7. Tangible personal property necessary for agricultural production, to be affixed to real property owned or leased by a farmer engaged in agricultural production for market. **Structural construction materials are not exempt from the tax.**
 8. State certified pollution control equipment and facilities *used primarily* for the purpose of abating or preventing pollution of the atmosphere or waters of the Commonwealth of Virginia.
 9. Computer equipment or enabling software purchased or leased for the processing, storage, retrieval, or communication of data, including but not limited to servers, routers, connections, and other enabling hardware, including chillers and backup generators used or to be used in a data center that is exempt from sales and use tax under Virginia Code § 58.1-609.3(18). **General building improvements and other fixtures are not exempt from the tax. A copy of the exemption letter issued by the Department to the Qualifying Data Center must be attached to this form.**

III. Procedures

- A. Real property typically means land along with its natural resources, such as timber, coal, ore, and precious stone, and structures permanently affixed to the land, such as houses and other buildings, but does not include temporary buildings or structures. To determine whether tangible personal property becomes real property after being affixed to realty, three general tests are applied: See Transcontinental Gas Pipe Line Corp. v. Prince William County, 210 Va. 550 (1970)
1. Annexation of the property to realty;
 2. Adaptation to the use or purpose to which that part of the realty with which the property is connected is appropriated, and;
 3. The intention of the parties involved, with the intention of the party making the annexation being the chief test to be considered in whether tangible personal property becomes realty.

In PD 06-142(12/8/06), the Tax Commissioner ruled that there is no legal basis to rely solely on federal depreciation classifications to distinguish tangible personal property from real property for local property tax purposes. Also, the Courts did not establish that the useful life of property or its accounting classification could be used to determine a party's intent to annex that property to realty. The Department may use the accounting classifications of property as a factor when determining intent, but cannot rely exclusively on this factor.

- B. A person who is a using or consuming contractor may also be engaged in the business of selling tangible personal property to customers, including contractors, for use or consumption by them. If so, the person is a dealer with respect to such sales, and is required to obtain a Certificate of Registration. After obtaining a Certificate of Registration as a dealer, a contractor may purchase the tangible personal property to be resold under a resale exemption certificate. He may not purchase under a resale exemption certificate any tangible personal property which he knows at the time of purchase will be furnished by him in connection with any specific contract.

If such a person, as a using or consuming contractor, removes from his sales inventory for use in the performance of any contract any tangible personal property purchased under a resale certificate, he must include the cost to him of such tangible personal property on his dealer's return and pay the tax.

- C. A dual role contractor is a manufacturer, processor or miner who operates in a dual capacity of fabricating tangible personal property for sale or resale and fabricating for his own use and consumption in the performance of real property construction contracts. Such dual role contractors shall follow a primary purpose rule based on gross receipts in determining sales and use tax application. If 50% or more of the contractor's gross receipts are derived from sales of tangible personal property, the contractor shall apply the tax according to paragraph (1) below. If 50% or more of the contractor's gross receipts are derived from real property construction contracts, the contractor shall apply the tax according to paragraph (2) below.

The primary purpose test is computed annually either on a fiscal or calendar year basis provided that the same basis is used consistently from year to year

by the Taxpayer. The primary purpose rule is computed separately for each facility of a company located in or doing business in Virginia. For such facilities, the primary purpose rule will apply to gross receipts regardless of whether they are from Virginia or non-Virginia sources. (See P.D. 93-91)

1. Any person who is principally fabricating tangible personal property for sale or resale should collect and remit the tax based upon the total amount for which tangible personal property and services are sold, except that charges for labor and services rendered in installing, applying, remodeling or repairing property sold may be excluded from the tax when separately stated or charged. In addition, any person who withdraws tangible personal property from inventory for use and consumption in the performance of real property construction contracts is liable for the tax based on the fabricated cost price of the tangible personal property withdrawn. Fabricated cost price is computed by totaling the cost of materials, labor, and overhead charged to work in process.
 2. Any person who is principally fabricating tangible personal property for his own use and consumption in real property construction contracts is classified as a using or consuming contractor and must pay the tax on the cost price of the raw materials which make up such fabricated property. The tax must be paid at the time of purchase to all suppliers who are authorized to collect the tax. In instances where the supplier is not authorized to collect the tax or fails to collect the tax, the tax must be remitted directly to the Department of Taxation on Form ST-7, Consumer's Use Tax Return. In addition, persons who sell tangible personal property to consumers must register, collect, and pay the tax on the retail selling price of the tangible personal property. Such person is entitled to purchase exempt from the tax only that tangible personal property which can be identified at the time of purchase as purchases for resale.
- D. A person selling and installing tangible personal property that becomes real property after installation is generally considered a contractor, except that a retailer selling and installing fences, venetian blinds, window shades, awnings, storm windows and doors, floor coverings (as distinguished from floors themselves), cabinets, kitchen equipment, window air conditioning units or other like or comparable items is not classified as a using or consuming contractor with respect to them.

For purposes of this subsection only, a "retailer" shall be deemed to be any person who maintains a retail or wholesale place of business, an inventory of the aforementioned items and/or materials which enter into or become a component part of the aforementioned items, and who performs installation as a part of or incidental to the sale of the aforementioned items. As so defined, a retailer is not classified as a using or consuming contractor with respect to installations of the aforementioned items. A retailer must treat such transactions as taxable sales except that installation charges when separately stated on an invoice are exempt from tax.

Note: No distinction is made between in-state and out-of-state retailers.

Persons who are not classified as retailers within the definition set forth above and who sell and install fences, venetian blinds, etc., are deemed to be contractors and must pay the sales tax on such items at the time of purchase.

The status of countertop installations was recently revised due to a law change. For specific details, please refer to PD 10-177, Va. Code § 58.1-610 D and the 2010 Legislative Summary for Senate Bill 57 .

Both retailers and contractors are deemed to be the users or consumers of supplies used in installing tangible personal property that becomes real property after installation. Therefore, retailers and contractors are subject to the tax on their purchases of tacks, stripping, glue, cement, and other supplies purchased.

- E. During the pre-audit conference with the contractor or his representative, the auditor should determine the contractor's business activities. The contractor may be a general contractor, subcontractor, retailer, dual role contractor, dealer-installer, or any combination of the above. This determination will dictate how the audit should proceed and the audit techniques to be employed by the auditor.

As applicable, the original contract/bid/proposal must be reviewed in detail to verify the scope of the work to be done, as well as that any tangible personal property provided that is considered a retail sale item was properly taxed.

- F. Many general contractors and home builders employ an "Auto Pay System" for paying subcontractors and suppliers. Under these systems, there are no invoices. For an agreed upon price, the subcontractor or supplier will perform a specific job, or supply the materials for a specific job. Once the task is completed, the general contractor or builder is notified, and payment is initiated. For additional information regarding Auto Pay, including pricing and record keeping requirements, please refer to PD's 96-28 & 94-298.

Field Audit Procedures – Sales & Use Tax



Topic: Sales Tax Charged and Paid in Error

Revised: December 2012

I. References

- A. Code of Virginia:
 - 58.1-611 (Credit for taxes paid in another state)
 - 58.1-609.10(4) (Delivery of tangible personal property outside of the Commonwealth for use outside of the Commonwealth)
- B. Virginia Administrative Code:
 - 23 VAC 10-210-450 (Credit for taxes paid to other states or their political subdivision)
 - 23 VAC 10-210-780 (Interstate and foreign commerce)
- C. Public Documents:
 - PD 87-227
 - PD-10-132
 - PD 94-195
 - PD-11-008
 - PD 01-135

II. General

- A. 58-1-611 of the Code of Virginia provides for a credit against the taxes imposed by the Commonwealth with respect to a person's use of tangible personal property in the Commonwealth for taxes paid in the state of purchase.
- B. 58.1-609.10(4) exempts from sales and use tax the delivery of tangible personal property outside the Commonwealth for use or consumption outside the state.
- C. 23 VAC 10-210-780 provides examples of transactions in interstate and foreign commerce to which the tax does not apply.

III. Procedures

- A. The interstate commerce exemption cannot be used to exempt transactions in which delivery of items purchased by the taxpayer occurs within Virginia. No credit is allowed for taxes erroneously charged or incorrectly paid to another state. The taxpayer must apply to the out-of-state seller for a refund.
- B. No credit is allowed for Virginia tax remitted to a vendor for purchases on which no tax or the wrong state's tax was charged. These transactions should be included in the audit exceptions and the taxpayer must apply to the vendor, whether in-state or not, or registered or not, for a refund of the tax paid. Voluntarily including the correct Virginia Sales Tax with the payment to the vendor does not assure that the tax will be remitted to the Department.
- C. If a taxpayer has erroneously paid Virginia tax on exempt purchases, the taxpayer must request a refund of the tax from its vendors. The erroneously paid taxes should not be included in the audit and credited against the audit liability.

Field Audit Procedures – Sales & Use Tax



Topic: Dealers

Revised: December 2012

I. References

- A. Code of Virginia:
58.1-612
- B. Public Documents:
PD 93-240
PD 94-10
PD 94-62
PD 95-250
PD 97-81
PD 00-53
PD 04-4
PD 08-106
PD 09-169

II. General

Sales tax is collectible from all persons who meet the definition of a dealer and who have sufficient activity within the Commonwealth.

III. Procedures

- A. Determine if the person meets the definition of a dealer through inquiry and examination of the business activity. The Code provides a list of all persons who meet the definition of a dealer:
 - 1. Persons who manufacture or produce tangible personal property for sale at retail, for use, consumption or distribution, or for storage to be used or consumed in this state.
 - 2. Persons who import or cause to be imported into this state tangible personal property for sale at retail, for use, consumption or distribution, or for storage to be used or consumed in this state.
 - 3. Persons who sell at retail, or who offer for sale at retail, or who have in their possession for sale at retail, or for use, consumption or distribution or for storage to be used or consumed in this state, tangible personal property.
 - 4. Persons who have sold at retail, used, consumed, distributed, or stored for use or consumption in this state, tangible personal property and who cannot prove that the tax has been paid on the sale at retail, the use, consumption, distribution or storage of the tangible personal property.
 - 5. Persons who lease or rent, or who are lessees or rentees of, tangible personal property for a consideration, without transfer of title thereto.

6. Persons who, as representatives or agents, solicit, receive, and accept orders for delivery into Virginia for an out-of-state principal who refuses to register as a dealer.
 7. Persons who become liable to and owe Virginia any amount of tax imposed by Virginia, whether they hold, or are required to hold, a certificate of registration.
- B. Determine if the dealer has sufficient activity in Virginia to require registration and collection of the tax:
1. Maintains or has within this state, directly or through an agent or subsidiary, an office, warehouse or place of business of any nature. Two factors are necessary for an agency relationship to exist (see section C).
 2. Solicits business in this state by employees, independent contractors, agents or other representatives.
 3. Advertises in this state by any of the following methods:
 - a. In newspapers or other periodicals printed and published in this state.
 - b. On billboards or posters located in this state.
 - c. Through continuous, regular, seasonal, or systematic solicitations broadcast or relayed from a transmitter within Virginia or distributed from a location in Virginia.
 - d. Through materials distributed in this state by means other than the United States mail, except for continuous, regular, seasonal, or systematic solicitations in which the dealer benefits from any banking, financing, debt collection, or marketing activities occurring in Virginia or benefits from the location in Virginia of authorized installation, servicing, or repair facilities.
 4. Makes regular deliveries within this state. There are two conditions that must be present:
 - a. Deliveries must be by other than a common carrier, e.g., dealer truck or contract carrier.
 - b. There must be more than 12 deliveries in a calendar year.
 5. Is owned or controlled by the same interests which own or control a business located within Virginia.
 6. Has a franchisee or licensee operating under the same trade name in this Commonwealth if the franchisee or licensee is required to obtain a certificate of registration.
 7. Owns tangible personal property that is rented or leased to a consumer in this Commonwealth, or offers tangible personal property, on approval, to consumers in this Commonwealth.
- C. Two factors are necessary for an agency relationship to exist:

1. First, the agent must be subject to the principal's control, with regard to the work to be done and the manner of performing it. Actual control is not the test; it is the right to control that is determinative.
 2. Second, the work has to be done on the business of the principal or for the principal's benefit.
- D. The dealer must perform one of the listed activities to require registration and collection of the tax.
- E. Nexus does not exist for an out-of-state seller whose only presence in Virginia is the use of a computer server to create or maintain a site on the Internet.
- F. Out-of-state persons who contract with a commercial printer in Virginia are not required to register solely because of their contractual relationship with the printer if their activities are limited to the following:
1. Owning or leasing tangible or intangible property at the printer's premises which is used solely in connection with the printing contract with that person.
 2. Selling property printed at and shipped or distributed from the printer's premises.
 3. Activities in connection with the printing contract with the person performed by or on behalf of that person at the printer's premises.
 4. Activities in connection with the printing contract with the person performed by the printer within Virginia for or on behalf of that person.

Field Audit Procedures – Sales & Use Tax



Topic: Cash vs. Accrual

Revised: December 2012

I. References

- A. Code of Virginia:
 - 58.1-615 (Returns by Dealers)
 - 58.1-616 (Payment to Accompany Dealer's Return)
- B. Virginia Administrative Code:
 - 23 VAC 10-210-480 (Dealer's returns and payment of the tax)

II. General

- A. Code of Virginia §58.1-615 states that every dealer required to collect or pay the sales or use tax shall, on or before the twentieth day of the month following the month in which the tax shall become effective, transmit to the Tax Commissioner a return showing the gross sales, gross proceeds, or cost price, as the case may be, arising from all transactions taxable under this chapter during the preceding calendar month, and thereafter a like return shall be prepared and transmitted to the Tax Commissioner by every dealer on or before the twentieth day of each month, for the preceding calendar month. Notwithstanding any other provision of this chapter, a dealer may be required by the Tax Commissioner to file sales or use tax returns on an accounting period less frequent than monthly. If a dealer is required to file other than monthly, each such return shall be due on or before the twentieth day of the month following the close of the period.
- B. In general, except as otherwise provided in this subsection, every dealer is required to file a return on or before the 20th day of the month following each reporting period even if no tax is due.

III. Procedures

- A. Determine that the taxpayer is reporting on a cash basis. There are different methods to determine the liability based upon the volume of the records, the dollar amount of the invoices, and the detail of records available.
- B. There are two areas of liability:
 - 1. The current accounts receivables represent sales that have not been reported on any sales tax return. These should be entered in the unremitted sales exceptions list during the month of the actual sale.
 - 2. No additional tax is due on charge sales made during the audit period that have already been paid and reported. A debit entry is made in the sales exceptions list in the month of the actual sale, and a credit entry is made in the month reported. A review of detailed accounts receivable for the audit period can be used to identify sale and payment dates. Also, a detail list

including sales dates may accompany the sales tax return worksheets each month.

Penalty, as applied below, and interest are to be assessed from the time the tax on the sales was due to the time the tax was actually remitted.

- C. On first audits, no penalty should be imposed on any sales tax previously remitted on the cash basis. Penalty will apply to unreported sales tax, i.e., tax on the current accounts receivables. The taxpayer should be instructed to remit on an accrual basis in the future.

On subsequent audits, penalty should be applied to all payments that were not reported or remitted on the return covering the month in which the sale was made. A debit entry should be made in the unremitted sales exceptions list in the month of the sale, and a credit entry should be made in the miscellaneous sales exceptions list in the month of the remittance.

This method will correctly compute the interest due. Penalty will also be computed correctly for the unreported sales, and for sales that were reported six months or more after the original sale (30% penalty is due). A manual calculation of penalty is required for all other sales that were remitted late.

Refer to the audit procedure for "Penalties and Interest" for more information on penalty and interest.

Field Audit Procedures – Sales & Use Tax



Topic: Fabrication

Revised: December 2012

I. References

- A. Code of Virginia:
58.1-602, 604
- B. Virginia Administrative Code:
23 VAC 10-210-560 (Fabrication)
23 VAC 10-210-410 (Contractors respecting real estate)
23 VAC 10-210-920 (Manufacturing and processing).
- C. Public Documents:
 - PD 05-45 Primary Purpose Test Fabricated Products
 - PD 04-101 Services Separately Stated Charges
 - PD 05-2 CD Fabrication- Data Conversion
 - PD 00-175 Manufacturing Fabricated Steel
 - PD 91-301 Fabrication by Subcontractor
 - PD 06-148 Fabrication by a Third Party
 - PD 09-15 Fabrication Labor
 - PD 11-77 Fabrication Labor
 - PD 01-218 Data Conversion/Transfer of Converted Data
 - PD 10-83 Fabrication Services not Subject to Use Tax
- D. Court Case:
PD 05-145 *Hardaway Construction Corporation of Tennessee v. Commonwealth of Virginia Department of Taxation* ().
- E. Exemption Certificates:
ST-10 (Resale)
ST-11 (Industrial Manufacturing)

II. General

- A. Virginia Code § 58.1-602 defines the term “sale” to include “the fabrication of tangible personal property for consumers who furnish, either directly or indirectly, the materials used in fabrication...” Title 23 of the Virginia Administrative Code (VAC) 10-210-560 A, defines fabrication as “an operation which changes the form or state of tangible personal property...” Traditionally, the Department has held tangible personal property that is cut, sawed, shaped, bent, threaded, welded, bored, drilled, punched, machined, sheared or otherwise subjected to an operation which changes the property’s form or state is considered to have been “fabricated.” These operations are deemed to be a taxable fabrication service in accordance with the statute and regulation cited, and the charge for such service is subject to sales tax. According to 23 VAC 10-210-560 B, “the tax applies to the total charge for the fabrication of tangible personal property, including labor, even if charges for

labor are separately stated.” Note that fabrication is distinguished from repair which is an operation that restores a used or worn piece of tangible personal property. Repair charges are governed by 23 VAC 10-210-3050.

The distinction that something new has been created, is key in differentiating between potentially taxable fabrication labor and exempt repair labor identified in Virginia Code § 58.1-609.5 (2). Fabrication labor makes or creates a product or alters an existing product into a new or changed product. For example, cutting a piece of metal creates two new pieces of metal; therefore, a change in the form or state of the original metal has occurred. The labor charge for cutting the metal is taxable. Repair labor restores an item so that it can be used for its original purpose. An example of repair labor is welding a broken or cracked piece of metal back to its original form. The labor charge, if separately stated, is exempt from tax.

- B. **Purchases of fabrication labor** - Code of Virginia §58.1-604 states that the use tax applies to “the use or consumption of tangible personal property in this Commonwealth.” The lack of language in this statute stating that the use tax applies to services led the Court to rule in *Hardaway Construction Corporation of Tennessee v. Commonwealth of Virginia, Department of Taxation* that, in instances where the consumer furnishes the materials used, although the seller may be assessed sales tax on untaxed fabrication labor charges, there is no statutory authority to assess the purchaser use tax on the same untaxed charges.
- C. **Sale at retail** - A person regularly engaged in the fabrication of tangible personal property for sale at retail must add the sales tax to the sales price and collect it from the customer for payment to the state. Raw materials, component parts, and other tangible personal property to be fabricated for sale may be purchased under a resale certificate of exemption. If the fabricator converts some of the property to his own use, he must pay the tax based on the fabricated cost (i.e. the cost to him) computed by totaling the cost of materials, labor and overhead charged to work in process. Freight inward to the plant on the materials is treated as an element of the cost of materials.
- D. **Fabricator respecting real estate** – A fabricator who contracts to perform services with respect to real estate construction, and in connection therewith to furnish tangible personal property for incorporation in real estate construction thereby causing it to lose its identity as tangible personal property by becoming real property, is classified as a using or consuming contractor and must pay the tax on the cost price of the raw materials which make up such fabricated property. The tax must be paid at the time of purchase to all suppliers who are authorized to collect the tax. In instances where the supplier is not authorized to collect the tax or fails to collect the tax, the tax must be remitted directly to the Department of Taxation on Form ST-7, Consumer Use Tax Return. Reference 23 VAC 10-210-410 for details.
- E. **Fabricator operating in dual capacity** – A manufacturer, processor, miner or business which operates in a dual capacity of fabricating tangible personal property for sale or resale and fabricating for his own use and consumption in the performance of real property construction contracts shall follow a primary purpose rule based on gross receipts in determining sales and use tax application. Any person who is principally fabricating tangible personal

property for sale or resale shall apply the tax according to subsection B above. Any person who is principally fabricating tangible personal property for his own use and consumption in real property construction contracts shall apply the tax according to subsection C above.

In addition, persons who sell tangible personal property to consumers must register, collect and pay the tax on the retail selling price of the tangible personal property. Such person is entitled to purchase exempt from tax only that tangible personal property which can be identified at the time of purchase as purchases for resale. If the person is unable to identify at the time of purchase the tangible personal property which will be resold, such person is required to pay the tax to his supplier. If, at a later date, the person sells the tangible personal property at retail, the tax is collected upon retail selling price. Such persons are not entitled to a credit for the tax paid to suppliers since the transactions are separate and distinct taxable transactions.

A person who fabricates tangible personal property, both for sale or resale and for use in real property construction contracts, may apply to the Tax Commissioner to pay any tax directly to the state and avoid the collection of tax by suppliers, if his purchases are made under circumstances which normally make it impossible at the time of sale to determine the manner in which such property will be used. See 23 VAC 10-210-510 on direct payment permits for further instructions.

- F. **Industrial Manufacturers** - Fabricators of tangible personal property may take the status of industrial manufacturers, processors or miners under 23 VAC 10-210-920 or 23 VAC 10-210-960 and when they fabricate tangible personal property for sale or resale, they may enjoy the production exemptions set out in 23 VAC 10-210-920 or the mining exemptions set out in 23 VAC 10-210-960. The production and mining exemptions are not available to a fabricator of tangible personal property who fabricates for his own use or consumption (as a contractor or otherwise) and not for sale or resale. However, a fabricator whose principal or primary business is the fabrication of tangible personal property for sale or resale, and who, as a lesser or minor part of this business, fabricates for his own use and consumption, will not be deprived of the production exemptions set out in 23 VAC 10-210-920, or the mining exemptions set out in 23 VAC 10-210-960.

III. Procedures

- A. Obtain an understanding of the taxpayer's operation. Discuss with the taxpayer the type of services provided. Inquire about specific jobs and examples of fabrication labor and repair labor. Once a clear understanding of the operation is obtained, determine the tax status of the fabricator (i.e. fabricator for sale at retail).
- B. Determine if the tax status directs you to implement the provisions from a more specific regulation. For example, if a fabricator (contractor) respecting real estate execute tax provision 23 VAC 10-210-410; if a manufacturer, utilize regulation 23 VAC 10-210-920; otherwise implement the regulation for fabricators 23 VAC 10-210-560.

- C. Be cognizant of the distinct difference between fabrication labor and repair labor. Understand the personal service exemptions in Virginia Code § 58.1-609.5 as well as other industry specific exemptions.

Field Audit Procedures – Sales & Use Tax



Topic: Floor Coverings - Flooring

Revised: December 2012

I. References

- A. Code of Virginia:
58.1- 609.5 258.1-610. A, B & D
- B. Virginia Administrative Code:
23 VAC 10-210-410. A., B & G (acting as a retailer)
- C. Virginia Tax Bulletin:
VTB 92-7
- D. Public Documents:
PD 84-189
PD 85-116
PD 85-194
PD 89-252
PD 90-42
PD 92-27
PD 96-115
PD 98-139
PD 10-141

II. General

Code of Virginia 58.1-610.D and 23VAC 10-210-410.G set forth the application of sales tax to floor coverings. Both discuss the application of tax to materials used by contractors in the performance of their contract jobs. The regulations and bulletin provide that "floor coverings" are distinguished from "floors" themselves and are defined to include rugs, mats, padding, wall-to-wall carpets when installed by the tack, strip, or stretch-in methods, and other floor coverings which are not glued, cemented, or otherwise permanently attached to the floor below. Floor coverings, which are glued, cemented, or otherwise permanently attached to the floor below, are deemed to be floors.

Persons who sell and install floor coverings are considered either a retailer or contractor. A person is considered a retailer of floor coverings if such person maintains a retail or wholesale place of business, an inventory of floor coverings or their component parts, and if that person performs installation as part of the sale of the floor coverings. The sale of "floor coverings," as described above, by a retailer constitutes retail sales and the retailer must collect the tax on the sales price of the floor coverings. A retailer, when selling and installing "floors" is deemed a using and consuming contractor with respect to the floors and must pay the use tax on the cost price of the floor covering. In both instances, the retailer must pay the use tax on materials used in the installation of floor coverings.

The tax does not apply to installation charges when separately stated on the invoice under Code of Virginia §58.1-609.5(2). If the installation charge is not separately stated, the tax must be computed on the total invoice charge.

A person selling and installing floor coverings, who is not a retailer, is considered a using and consuming contractor with respect to such items, regardless of the method in which the floor covering is installed. The contractor is subject to the tax on the costs of all materials used in the performance of the contract work and the tax is not collected from the purchaser.

Both retailers and contractors are deemed to be the users or consumers of supplies used during the installation. Therefore, both retailers and contractors are subject to the tax on their purchases of tacks, stripping, glue, cement, shoe molding, and other purchased supplies

III. Procedures

A. Contractor (No retail or wholesale place of business with no inventory)

This type of business is considered a using and consuming contractor with respect to floor coverings, regardless of the method in which the floor covering is installed. The contractor is subject to the tax on the costs of all materials used in the performance of the contract work and the tax is not collected from the purchaser.

B. Retailer (Has a retail or wholesale place of business and inventory)

A retailer shall be deemed to be any person who maintains a retail or wholesale place of business, an inventory of floor coverings and/or materials which enter into or become a component part of the aforementioned items, and who perform installation as part of the sale of such items.

Carpet Installed Tacked Down: Carpet installed by the tack strip method is not permanently affixed to realty. Therefore, this would be considered a floor covering and classified as a retail sale.

Permanent "Double-Stick" Carpet, Tile and Laminate Installation: Both the cushion and the carpet are permanently glued down, thus this would be classified as contract work.

Releasable "Double-Stick" Carpet, and Laminate Installation: The carpet is attached to the cushion using a releasable adhesive, thus this would be considered a floor covering and classified as a retail sale.

Permanent Modular Carpet Installation: The carpet tiles are permanently glued down and the entire substrate is covered with permanent adhesive, thus this would be considered contract work.

Releasable Full Spread Modular Carpet and Laminate Installation: If the carpet can be removed without material injury to the carpet/laminate or to the real estate, this would be considered a floor covering and considered as a retail sale.

Releasable Grid System Modular Carpet Installation: The carpet can be removed with no damage to the substrate, thus this would be classified as a floor covering and considered as a retail sale.

Releasable Perimeter Glue Carpet or Vinyl Installation: This is a loose lay installation with only releasable adhesive used on the perimeter of the carpet or vinyl, thus this would be classified as a floor covering and considered as a retail sale.

Floating Floors: This consists of tongue and groove planks that are glued together to create a sheet of laminate flooring. The flooring is laid on top of the layer of foam and secured by moldings around the perimeter. This type of flooring is distinguished from the floor themselves and is considered a retail sale.

Fully Glued Down or Otherwise Permanently Attached Wood or Vinyl Flooring: Glued down or nailed down wood flooring or fully glued vinyl flooring becomes permanently affixed to realty. Therefore, this would be considered contract work.

Releasable Full Spread Modular Carpet Installation: If the carpet can be removed without material injury to the carpet or to the real estate, this would be considered a floor covering.

Field Audit Procedures – Sales & Use Tax



Topic: Landscapers & Nurserymen

Revised: December 2012

I. References

- A. Code of Virginia:
 - 58.1-609.2(1) (Agriculture exemption)
 - 58.1-609.5(9) (Maintenance contracts)
 - 58.1-610 (Contractors)
- B. Virginia Administrative Code:
 - 23 VAC 10-210-50 (Agriculture)
 - 23 VAC 10-210-410 (Contractors respecting real estate)
 - 23 VAC 10-210-610 (Florists and nurserymen)
 - 23 VAC 10-210-910 (Maintenance contracts and Warranty plans)
- C. Virginia Tax Bulletin:
 - VTB 95-8 (PD 95-247) Parts and Labor Maintenance Contracts.
- D. Public Documents:
 - PD 97-320 Tax must be separately stated on invoice.
 - PD 96-68 Tax must be charged on the total of a lump sum billing.
 - PD 08-4 Contractor not responsible for charging tax on sod
 - PD 07-171 New policy for landscape & construction contractors.
 - PD 96-71 Plant replacement maintenance contract is not a real property maintenance contract.
 - PD 96-19 Plant replacement maintenance contract is taxable at 50%.
 - PD 87-172 Landscaper may show one lump sum total for all plants.
 - PD 87-172 Landscaper is retailer for trees, shrubs, etc. - not a contractor.
 - PD 86-214 Maintenance contract w/o plant replacement gtd. is service.
 - PD 86-58 Immovable silos are taxable.
 - PD 84-126 Tests to determine if tpp becomes real property after install.
 - PD 82-153 Exempt items for greenhouse facilities.
 - PD 00-207 200-694 (CCH) Plastic covered greenhouse is taxed as is the plastic
- E. Exemption Certificate:
 - ST-10 (Resale)
 - ST-18 (Farmer)

II. General

- A. **Prior to November 2007:** Landscapers, landscape contractors, nurserymen, florists and any other businesses that sold and transplanted trees, shrubs, flowers, sod, silt fences, nursery stock and like items were treated as dealers making retail sales and were required to charge sales tax on the total charge. However, a charge for transplanting (labor) was not subject to tax if separately stated on the invoice. The sale and installation of trees, shrubs,

flowers, sod, silt fences, nursery stock and like items was always considered a retail sale, regardless of the type of business that engaged in these types of transactions.

November 2007 and after: A policy change was enacted to apply to landscapers, real property contractors and other similar businesses that primarily earn revenue providing services to real property. "Providing services to real property" requires the vendor/contractor to install the items being sold. These businesses will operate as consuming contractors rather than retailers when furnishing and installing trees, shrubs, flower, sod, silt fences, nursery stock and like items. However, if these dealers provide these items to their customers without installation, then the transaction will continue to be considered a retail sale and subject to tax as before.

The change of policy does not apply to establishments such as florists, nurserymen, garden centers, home improvement stores, greenhouse operators and similar retail businesses that sell and install trees, shrubs, nursery stock and plants. These businesses will continue to treat the sale and installation of these types of items as retail sales transactions subject to tax.

- B. **23 VAC 10-210-610** describes the general tax treatment of retail establishments such as florists, nurserymen, garden centers, home improvement stores, greenhouse operators, and similar businesses.

The policy change in PD 07-171 supersedes Paragraph C with respect to landscape contractors. Any landscaper, real property contractor and other similar businesses who "provides services to real property" by spreading, grading or otherwise installing shrubbery, sod, seed, fertilizer, etc. is deemed to be a consumer of all tangible personal property at the time of purchase. These type businesses typically purchase the nursery stock that is installed from suppliers. No sales tax should be charged for real property services.

C. Working Definitions:

1. **"Landscaper"** is used generically to indicate a landscape contractor, nurseryman or other person who performs landscaping.
2. **"Landscape contractor"** refers to any landscaper or other person as described in paragraph (C) of the regulation. A true landscape contractor does not have a retail business such as a garden center. The primary business usually involves grading, seeding, fertilizing and maintaining existing lawns as well as establishing lawns and landscaping for new construction. In addition, a landscape contractor may sell and install many of the items specifically designated as retail sales under paragraph (A) of the regulation. Note: Silt fences are considered part of landscaping – chain link or stockade fencing is not within these Procedures (see 23 VAC 10-210-410(g) for proper application of sales tax to these fence items).
3. **"Listed items"** refers to the items itemized in paragraph (A) of the regulation. They include flowers, potted plants, shrubbery, nursery stock, sod, wreathes and similar items.
4. **"Nurseryman"** designates any landscaper or other person who grows some or all of the listed items which are sold to customers; or someone

who operates a retail or wholesale business which carries a stock of such items. A nurseryman who grows nursery stock for market enjoys the agriculture exemption set out in 23 VAC 10-210-50. A nurseryman also acts as a landscape contractor anytime he goes beyond the sale and planting of shrubbery, sod, etc. and enters into landscape contracts as described in paragraph (C) of the regulation. However, if a nurseryman is primarily engaged in the provision of real property services, he will be treated as a landscape contractor rather than as a nurseryman.

5. **Real Property Services** include construction site preparation, excavation, erosion control, drainage and irrigation system installation, hauling of construction debris, grading, seeding, mowing, fertilizing, pruning of trees and shrubs, and similar activities.

D. General Taxability of Landscapers:

Landscapers, whether landscape contractors, real property contractors or nurserymen must register and charge sales tax whenever they make sales of the listed items without installation or transplanting.

Landscapers that contract to grade, seed and/or fertilize lawns are treated as consuming contractors with respect to their purchases of seed, fertilizer, mulch, straw, tools, supplies and equipment.

Landscapers that are primarily engaged in the provision of real property services, as defined in Section C above, and that also from time to time may sell and install trees, shrubs, plants, silt fence, sod and similar materials will operate as using and consuming contractors rather than as retailers. If a vendor selling tangible personal property to a landscaper does not charge the sales tax, the landscaper will be responsible for remitting use tax on the untaxed purchases to the Department.

E. General Taxability of Nurserymen and Florists:

The provisions of VAC 10-210-610 will continue to apply to retail establishments such as nurserymen, florists, and similar businesses that sell and install trees, shrubs, nursery stock, and plants. These businesses will continue to treat the sale and installation of these types of items as retail sales transactions and collect the applicable sales tax from customers. Installation charges will continue to be exempt from sales tax when separately stated on the sales invoice.

III. Procedures

A. First Audit

The sales tax registration status of the landscaper during the period under audit determines how the audit will be conducted.

1. Landscaper not Registered to Collect Sales Tax – First Audit

A landscaper who is making retail sales and not charging/collecting sales tax and is not registered to collect sales tax or is only registered to remit consumer use tax will be audited as the business was operating during the audit period. Tax will be assessed on purchases on which no tax was paid to the vendor or on which no consumer use tax was remitted by the landscaper. The audit comments should note how the business operated

and confirm that the landscaper was informed of the correct operating procedures. The landscaper will be properly registered and provided with forms and instructions on proper charging and remittance of the sales tax. The auditor will include the effective Beginning Liability Date of the sales tax registration in the audit comments.

2. Landscaper Registered to Collect Sales Tax – First Audit

A landscaper who is registered to collect sales tax should be held accountable for the proper business operation as described in 23 VAC 10 210-610.

B. Issues Regarding the Taxability of Landscape Contractors

1. General: A landscape contractor that is primarily engaged in the provision of real estate services operates as a consuming contractor and will pay tax on all tangible personal property it purchases for use in the provision of its services.

2. Exemption Certificates - Landscape Contractors: A landscape contractor may use Form ST-10 to purchase listed items exempt from the tax only if it knows at the time of purchase that it will resell the listed items without installation or transplanting onto the property of its customer. In such cases, the landscape contractor must charge tax on the selling price of the listed items, unless it has received a valid exemption certificate from its customer. A resale certificate (ST-10) can never be accepted in good faith for sales of listed items which the landscape contractor installs or transplants. It is also imperative that landscape contractors realize the difference between making a retail sale and fulfilling the service portion of a landscape contract. While acting as a consuming contractor, the landscape contractor is responsible for paying the tax on purchases of trees, shrubs, nursery stock, seed, fertilizer, and similar items for installation. The sales tax exemption status of the customer is not relevant to purchases of items used and consumed by landscape contractors.

3. Purchases by Landscape Contractors: A landscape contractor that is primarily engaged in the provision of real estate services operates as a consuming contractor, and will pay tax on all purchases of tangible personal property for use and consumption.

Any purchases of installation supplies (i.e., top soil, peat moss, fertilizer, mulch, stakes and wire), trees, shrubs, flowers, nursery stock, and equipment (i.e., shovel, rake, auger, and backhoe) are taxable to the landscape contractor at the time of purchase.

4. Invoices and Billing: A landscape contractor that is primarily engaged in the provision of services to real estate operates as a consuming contractor. *Contractors should not charge any sales tax on billings or invoices for real estate services.*

If a landscape contractor makes sales of listed items without installation or transplanting onto the property of its purchaser more than three times a year, it is required to register and collect tax on the retail selling price of

the listed items sold without installation or transplanting. *The amount of sales tax charged should be a separate line item on the billings or invoices.*

5. Examples of other tangible personal property (TPP) that becomes Real Property when Installed by a Landscape Contractor: A landscape contractor that is primarily engaged in the provision of real estate services must pay tax at the time of purchase of items such as landscape timbers, edging, walkways (gravel, rock, slate, etc.), decks, decorative boulders and other similar items.
6. What other TPP becomes Real Property when Installed by a Landscape Contractor?

The auditor has to determine the tax status of TPP which is not similar to the listed items installed by a landscape contractor. PD 84-126 explains the tests set forth by the Virginia Supreme Court in *Transcontinental Gas Pipe Line Corporation v. Prince William County*, 210 Va. 550 (1970).

(Note: PD 84-126 erroneously shows the year of the court case as 1969)

The classification of property as real estate or as tangible personal property is to be determined by the law of fixtures ... three general tests are applied in order to determine whether an item of personal property placed upon realty becomes itself realty. They are:

- a. annexation of the property to the realty.
- b. [adaptation] to the use or purpose to which that part of the realty with which the property is connected is appropriated, and
- c. the intention of the parties . . .

The intention of the party making the annexation is the chief test to be considered ...

With these tests in mind, most TPP (other than some of the listed items) installed by a landscape contractor becomes real property. The classification of items such as a decorative pond or a fountain is open for interpretation. For example, if hard wired or plumbed in, it would most likely be considered realty after installation. If each winter it must be brought indoors to protect from freezing, then it would retain its status as TPP.

C. Issues Regarding the Taxability of Nurserymen

1. Nurserymen vs. Landscape Contractors: A nurseryman is usually more familiar with making retail sales than a landscape contractor and is probably already registered to collect sales tax. Consistent with the policy change of November 2007, a nurseryman primarily earns its revenue from retail sales, and not from the provision of services to real estate. A nurseryman acts as a consuming contractor whenever it enters into landscape contracts to perform grading, seeding, fertilizing, etc. A nurseryman enjoys the agricultural exemption if he grows nursery stock for market.
2. Similar Items: 23 VAC 10-210-610(A) requires that a landscaper be treated as a retailer of listed items including any similar items. The

regulation's intent was to include in the term "similar items" only those items which are live or were grown. Although many of these items appear to become real property when transplanted, the definition of "retail sale" found in Code of Virginia §58.1-602 states that all sales for resale must be made in strict compliance with the regulations.

3. 23 VAC 10-210-50 - Agriculture Exemption: The agriculture exemption is available to nurserymen who are considered to be farmers when growing their plants or nursery stock. The agriculture regulation provides that:

[t]he tax does not apply to seed, plants, fertilizers, liming materials, agricultural chemicals, farm machinery, and agricultural supplies sold to farmers for use in agricultural production for market. Also, the tax does not apply to tangible personal property, except structural construction materials, necessary for use in agricultural production for market when sold to or purchased by a farmer or contractor or furnished to a contractor by a farmer to be affixed to real property owned or leased by a farmer.

The term "structural construction materials" includes but is not limited to silos; barns and sheds; storage bins (not portable); greenhouses, including plastic covered houses; permanent fencing; fuel oil storage tanks; electrical wiring, except wiring running from special purpose equipment to an on-off switch, plumbing, except as part of special purpose equipment. These items are therefore subject to tax.

The term "structural construction materials" specifically excludes the following but may also exclude other items: heating systems, power outage and water pressure alarm systems; ventilating equipment, to include air inlets, curtains and curtain cables, cords and related fixtures, pull-ups, winches, fans and fan belts, louvers, shutters, motors, static pressure gauges, thermostats and replacement parts; shade cloth; and irrigation lines and sprinkler heads. These items are therefore exempt from tax.

4. Exemption Certificates – Nurserymen: Nurserymen use the ST-10 resale exemption certificate to buy products for resale. In addition, nurserymen should use the ST-18 exemption certificate to make purchases which fall under the agriculture exemption. Exempt purchases would include such things as seedlings, potting soil, black plastic ground cover, mulch, vermiculite, pots, weed killer, pruning shears, irrigation or misting systems, heating and ventilation systems if they are for the survival of the plants, tillers and other farm equipment directly used in growing the nurseryman's products. (It is important to limit the definition of excluded structural construction materials to those items within or attached to an agricultural building.) If a contractor installs exempt attachments to realty, he must contact the department to obtain an ST-11A Certification of Exemption.
5. Greenhouses and Shade Cloth: Greenhouses, including plastic covered houses, are specifically designated as taxable structural construction materials. This includes the plastic covering itself. However, plastic

shade cloth hanging inside a greenhouse is specifically excluded from the term structural construction materials and is exempt. Shade cloth used in the fields would also be exempt.

6. Withdrawals from Exempt Resale Inventories: Nurserymen are more likely than landscape contractors to have exempt resale inventories of consumable supplies such as mulch, topsoil, fertilizer etc. If the nurseryman has a retail business, these items are often sold over the counter. Withdrawals from exempt inventories used by nurserymen when acting as consuming contractors are subject to tax.

D. Mulch, Top Soil, Stone and other TPP Delivered in Bulk

A landscape contractor that primarily earns its revenue from the provision of services to real estate may from time to time deliver mulch, topsoil, stone and other TPP in bulk to the customer without being spread. For example, the landscape contractor may drop a load of mulch in the driveway and drive away leaving the customer responsible for its distribution. In this case, the landscape contractor must charge his customer the tax. Conversely, if the landscape contractor spreads the mulch, he is acting as a consuming contractor and must pay the tax at the time of purchase. When acting as a consuming contractor, the landscape contractor does not charge his customer tax, but takes the tax into account in quoting a price to his customer.

A nurseryman that delivers mulch, topsoil, stone and other TPP in bulk to the customer without being spread must also charge tax on the selling price of the product provided. If the nurseryman spreads the mulch, he is acting as a consuming contractor and must pay the tax at the time of purchase or withdrawal from inventory.

E. Plant Maintenance Contracts Sold by Retailers

Plant maintenance contracts that provide for plant replacement are treated as "parts and labor maintenance contracts" covered under 23 VAC 10-210-910 and Virginia Tax Bulletin 95-8. These contracts are taxed at one-half (50%) of the total charge. A landscaper may purchase or withdraw plants for free replacement under the terms of a maintenance contract, from an exempt resale inventory without incurring a consumer use tax liability. Consumable items and installation or transplanting supplies and equipment are subject to the tax at the time of purchase or withdrawal from an exempt resale inventory.

Plant maintenance contracts, which only provide for the regular watering, fertilizing, mulching, pruning, etc. and do not included the provision of tpp, are service contracts not subject to the tax.

A landscape contractor that primarily earns its revenue from real estate services would not collect sales tax on plant maintenance contracts.

- F. Sale of Equipment: A landscaper registered for the collection of sales tax cannot make an occasional sale of equipment if that equipment was used in the activity for which he is required to hold a certificate of registration.
- G. Records: In order to qualify for the policy change instituted in November 2007, landscape contractors should be able to document that their revenue primarily comes from the provision of real estate services.

Field Audit Procedures – Sales & Use Tax



Topic: Food Tax Reduction Program

Revised: December 2012

I. References

- A. Code of Virginia:
58-1.611-1
- B. Virginia Tax Bulletins:
VTB 99-11 / PD 00-296
VTB 05-7 / PD 05-78

II. General

- A. As a result of legislation enacted by the 1999 General Assembly, the Food Tax Reduction Program reduces the **state** sales and use tax rate on food purchased for human consumption. The law change **does not** affect the imposition of the 1% local sales and use tax. Effective 7/1/2005, the combined state and local food tax rate was reduced to 2.5% (1.5% state, 1% local). The rate will stay at 2.5% absent further legislation.
- B. Food for home consumption by humans, as defined under the Food Stamp Act of 1977, 7 U.S.C. § 2012, qualifies for the reduced sales tax rate. The definition includes most staple grocery food items and cold prepared foods packaged for home consumption. Specifically **excluded** from the definition of food for home consumption are **alcoholic beverages, tobacco, and prepared hot foods** sold for immediate consumption on and off the premises. The reduced sales and use tax rate also does not apply to **seeds and plants which produce food** for human consumption.
- C. 80% Rule – Fast Food Establishments and Restaurants.

As defined in § 58.1-611.1, "food purchased for human consumption" **shall not include** food sold by any retail establishment where the gross receipts derived from the sale of food prepared by such retail establishment for immediate consumption on or off the premises of the retail establishment constitutes more than 80 percent of the total gross receipts of that retail establishment, including but not limited to motor fuel purchases, regardless of whether such prepared food is consumed on the premises of that retail establishment.

Basically, this means that food sold by most fast food establishments and restaurants **does not qualify for the reduced food tax rate**. This is true regardless of whether the food is for dine-in or take-out. Ineligible businesses are not required to keep separate records for take-out orders.

- D. **Retailer Classifications:** Generally, the following retailers should charge the reduced sales tax rate on sales of eligible food and beverages: bakeries, cafes, convenience stores, delicatessens, department stores, doughnut and pastry shops, drug and sundry stores, farmer's markets, grocery stores, ice

cream shops, mail order companies, supermarkets, specialty meat and produce stores, video stores, and weight reduction establishments.

Exceptions. Some vendors are presumed sellers of food for immediate consumption and **may not impose the reduced sales tax rate** on sales of eligible foods. These include caterers, concession vendors, cafeterias, entertainment facilities (theme parks, sports arenas, stadiums), fair and carnival vendors, hamburger and hot dog stands, honor snack vendors, ice cream stands and trucks, mobile food vendors, movie theaters, newsstands, and vending machine vendors.

E. **Eligible Foods & Beverages:** The following lists are for example only and are not intended to be all inclusive:

- ✓ Staple Food Items - Fruits, Vegetables, Meats, Dairy Products, Breads, Egg Products, Canned Foods, Frozen Foods, Grain Products, Flour Products, Nuts, Sugar Products, etc.
- ✓ Accessory Food Items - Bottled Drinking Water, Sodas, Fruit Juices, Cocoa Products, Coffee Products, Tea Products, Spices, Extracts, etc.
- ✓ Snack Foods - Candy, Chips, Popcorn, Granola Bars, Jerky, etc.
- ✓ Bakery Foods - Bagels, Brownies, Cakes, Donuts, Cookies, Pies, Bread, etc.
- ✓ Cooking Ingredients - Baking Products, Vegetable Oils, Cooking Sprays, Shortening, Cooking Wine, etc.
- ✓ Health Food Items - Soy Milk, Acidophilus Milk Products, Brewer's Yeast, Wheatgerm, etc.
- ✓ Specialty Dietary Foods - Diabetic Foods, Boost, Ensure, Enfamil, PediaSure, Slim Fast, Weight Watchers, Herbalife, etc.
- ✓ Cold Prepared Foods - Sold In Single or Multiple Serving Sizes and Packaged For Home Consumption. - Prepackaged Cold Sandwiches, Prepackaged Cold Salads, Cold Salads Prepared By The Customer and Packaged In A To-Go Container, Take-Home Cold Dinners Packaged For Home Consumption, Cold Fountain Drinks With Lids, Ice Cream Served In Containers With Lids, Cold Deli Trays And Party Platters Packaged In Containers With Lids, Uncooked Pizzas Packaged For Home Consumption, etc.
- ✓ Samples and giveaways - Samples, free distributions, and giveaways of eligible food products by food wholesalers and retailers are subject to the reduced sales and use tax rate unless otherwise exempt from the tax.

F. **Ineligible Food and Items:** The following lists are for example only and are not intended to be all inclusive:

- ✗ Alcoholic beverages, tobacco products, seeds or plants which produce food, vitamins, canning supplies, cleaning products, cooking utensils, cosmetics and beauty aids, freezer bags and containers, health aids, household items, medicines, minerals, paper products, pet and animal foods and supplies, soaps and detergents, toiletry items, and tonics.
- ✗ Catered foods and meals.

- × Hot foods and hot beverages (including hot meals)
Exceptions: Meals On Wheels, Drug & Alcohol Rehab Centers, Shelters For Battered Women, etc. (See P.D. 05-78 for a complete listing).
- × Cold food and cold beverages served in open containers or on plates, platters and trays for immediate consumption.
- × Eligible food packaged with ineligible food, nonfood items, or alcoholic beverages and sold together for a single price.
Example – Gift Baskets.
- × Food marketed or advertised for heating in the store whether or not hot at the point of sale.
Example – A convenience store that provides a microwave and advertises that the eligible food items are “hot-to-go,” such as breakfast biscuits, pizza slices, etc.
- × Food and beverages kept hot to make them palatable and suitable for immediate consumption on or off the premises.
Example – Fried Chicken or other hot foods under heat lamps; hot beverages in pots with a heat source.
- × Cold sandwiches, cold salads, and cold beverages sold in combination with hot foods for a single price .
Example – Combo meal at a convenience store.

III. Procedures

A. Sales Tax Audits

Determine which items have been taxed as “food purchased for human consumption.” Larger retail food stores can provide you with a listing of items taxed at the reduced rate. Identify the items that may not qualify for the reduction. Note such items and discuss with the taxpayer.

If the taxpayer cannot provide you with a list, test the register tapes to identify possible exceptions. When testing the register tapes, verify the “total” tax from the tapes as posted to the daily closing sheets, then to the monthly closing sheets and to the sales tax return. If there are no register tapes, use the best information available.

As always, when auditing a retail food store, verify the handling of food stamps and WIC coupons. With the food tax reduction, new issues may arise.

B. Consumer Use Tax Audits

Business establishments are required to pay the consumers use tax on untaxed purchases of tangible personal property for use in Virginia, which are not otherwise exempt of the tax. Under the Food Tax Reduction Program, businesses should pay the reduced sales tax rate on untaxed purchases of eligible food products.

The same applies to individuals on total untaxed purchases of more than \$100 in a calendar year.

FIELD AUDIT PROCEDURES – SALES & USE TAX

Topic: Government Contractors

Revised: December 2012

I. References

- A. Code of Virginia:
 - 58.1-609.1 (Governmental and commodities exemptions)
- B. Virginia Administrative Code:
 - 23 VAC 10-210-410.J (Contractors respecting real estate)
 - 23 VAC 10-210-690 (Government; Sales to)
 - 23 VAC 10-210-691 (Government; sales by)
 - 23 VAC 10-210-692 (Government areas; sales within)
 - 23 VAC 10-210-693 (Government Contractors)
- C. Virginia Tax Bulletins:
 - VTB 95-8
 - VTB 06-4
- D. Public Documents:

PD 88-159	PD 88-249	PD 89-154
PD 89-206	PD 91-247	PD 92-4
PD 92-179	PD 93-20	PD 93-170
PD 93-181	PD 93-186	PD 93-191
PD 93-203	PD 93-238	PD 93-241
PD 94-115	PD 94-140	PD 94-155
PD 94-201	PD 94-218	PD 94-231
PD 94-238	PD 94-267	PD 94-270
PD 94-334	PD 94-335	PD 95-16
PD 95-28	PD 95-42	PD 95-77
PD 95-80	PD 95-82	PD 95-91
PD 95-97	PD 95-99	PD 95-124
PD 95-139	PD 95-293	PD 95-313
PD 95-314	PD 95-323	PD 95-329
PD 95-333	PD 96-23	PD 96-48
PD 01-6	PD 06-60	PD 06-61
PD 06-137	PD 07-84	PD 07-98
PD 07-139	PD 08-116	PD 08-154
PD 08-180	PD 08-190	PD 09-84
PD 09-117	PD 10-27	PD 10-105
PD 10-137	PD 10-177	PD 10-280
PD 11-10	PD 11-56	PD 11-70
PD 11-128		

- E. Exemption Certificates:
 - ST-10 (Resale)
 - ST-11 (Manufacturing)
 - ST-12 (Government)
- F. Court Cases:
 - U.S. vs. New Mexico, et al (U.S. Supreme Court)*
 - U.S. and Hercules vs. W.H. Forst, State Tax Commissioner, et al (U.S. District Court for the Western District of VA)*

II. Significant Terms

- **DCAA** - Defense Contract Audit Agency. Audits government contractors for compliance with Federal Acquisition Regulations.
- **FAR** - Federal Acquisition Regulations. FARs are used by all federal executive agencies for acquisition of supplies and services with appropriated funds. FAR, together with agency supplemental regulations (such as the Department of Defense FAR Supplement that applies to all Defense agencies), should be the primary guideline for the contractor's conduct in administering the contract.
- **SOW** – Statement of Work. A general statement of the overall objective of the government contract. The statement should be a primary source for determining the "true object" (service vs. sale of tangible personal property) of the contract or individual task orders. This term is also defined in Title 23 VAC 10-210-693 A.
- **RFP** - Request for Proposal. A document developed by the government to apprise the prospective bidder of the type of contract the government requires, such as the general specifications of the items or services to be provided. Usually, the RFP is not a classified document.
- **Contracting Officer** - A government employee who oversees the progress of a government contract and works with the contractor to facilitate progress and completion of a contract.
- **TWR** - Technical Work Request. Task orders within a contract.
- **ID/IQ** – Indefinite Delivery / Indefinite Quantity
- **Add-ons** - Additional obligations subsequent to the execution of the original contract or order, including modifications to contracts or orders.
- **Order** - Specific task assigned to a contractor pursuant to a contract with a government entity. For purposes of the government contractors regulation (i.e., Title 23 VAC 10-210-693), the term "order" shall include, but not be limited to, task orders, delivery orders, work orders, contract line item numbers (CLINs), and shall also include orders issued under a subcontract for fulfillment of work or products required under a general contractor's prime contract with the government and add-ons to existing contracts or orders.

The term "order" shall not include a vendor order issued by a contractor to a vendor. A vendor order is defined in Title 23 VAC 10-210-693 A.

- **Reference information** - There is a wealth of federal government contractor information available online. For example, the FAR can be found at www.acquisition.gov/FAR/.

III. General

Prior to July 1, 2006, a government contractor could operate as a retailer or service provider based upon the "true object" of the underlying contract. When the "true object" of the contract involved a sale of tangible personal property, the contractor could purchase the resale inventory with an ST-10 certificate of exemption.

A government contractor who performs a service and in conjunction therewith furnishes some tangible personal property is generally deemed to be the consumer of all such property and is not entitled to exemption on the grounds that a governmental entity is a party to the contract. This is true even though title to the property provided may pass to the government and/or the contractor may be fully and directly reimbursed by the government.

Contractors providing services are the consumers of all equipment and supplies absent any statutory exemptions such as research and development.

On July 1st, 2006, the Virginia Department of Taxation changed its interpretation of the true object test under the Retail Sales and Use Tax as it applies to contractors doing business with the federal, state and local government. Effective for "work orders", "statements of work," and "task orders" entered into on and after July 1, 2006, the Department must make a taxability determination regarding the true object of the transaction entered into with the government entity based upon the true object of each separate "work order", "statement of work" and "task order," rather than the true object of the underlying contract between the government entity and such contractor.

IV. Procedures

During the pre-audit conference and tour, the auditor should determine if the contractor makes sales of tangible personal property. If such sales are to customers other than the government, the sales transactions should be reviewed to ensure the proper application of the tax. For example, sales by the contractor to other government contractors are not entitled to the exemption afforded the U.S. government. Such sales are taxable in the absence of a valid exemption certificate. A registered contractor can purchase resale inventory exempt from tax using the ST-10 certificate.

In those cases when the contractor provides services to the government, the relevant contracts must be reviewed to verify consumer use tax compliance.

Note that actual audit procedures will be determined based on the size of the company, the way records are kept, the volume of transaction, etc.

For contracts entered into prior to July 1st, 2006, the "true object" test must be applied when examining contracts by reviewing the "statement of work (SOW)." The determination is generally made at the overall contract level and not at the "task" level. [An exception to this former policy applies for ID/IQ contracts, basic ordering agreements, and technical direction letters in which the Tax Commissioner has determined that the true object test must be applied to individual task orders rather than to the underlying contract. See P.D. 01-6 (1/4/01) and P.D. 09-52 (5/1/09)] The SOW of the prime contract will explain the scope of the contract and the product or service to be provided by the contractor. An analysis of the SOW is essential in determining the "true object" of the transaction.

When reviewing the SOW, the auditor should be aware of potential manufacturing, resale, or research and development exemptions. An example of a resale contract would involve the sale of a computer system to the government; a service contract, however, may include furnishing, operating, and maintaining the computer system. The auditor must determine if the government entered into the contract for the primary purpose of securing tangible personal property or to obtain services from the contractor.

In reviewing the SOW, the auditor should carefully consider key terms such as "operate," "maintain," or "manage." Such terminology could be indicative of a service contract and purchases charged to that contract may be fully taxable to the contractor absent another exemption such as R&D. See P.D. 07-98 (6/27/07) when the operational requirement is of incidental scope and duration.

If it has been determined that the contractor is providing services to the government, emphasis is placed on reviewing expense purchases as well as asset acquisitions. Expense purchases examination includes both direct charges to the contract and indirect charges.

Effective on and after July 1st, 2006, the General Assembly mandated a change to the above mentioned application of the true object test to contractors who provide services to the United States, the Commonwealth of Virginia, and any political subdivision or instrumentality thereof. After such date the Department applies the true object test to the statement of work for each task order or work order issued pursuant to a prime contract (except for real estate construction contracts) with any of the above government entities. This policy change is not retroactive to any period prior to July 1st, 2006. While the policy change has no effect on prime contracts for the periods prior to July 1st, 2006, it would apply to work orders issued under the prime contracts after June 30, 2006. For add-ons to government contracts executed on or after July 1st, 2006, the true object test will be applied to each separate add-on without regard of the true object of the original contract.

For contracts entered into on or after July 1, 2006, the contractor must supply the auditor with the statement of work for each specific task in question associated with the purchase of tangible personal property that is under review. There may be instances in which the underlying contract will need to be reviewed to gain better understanding of the individual task orders. In addition, other records as set out in Title 23 VAC 10-210-693 M may be needed for review of the contract.

In the absence of a security clearance, classified contracts may not be available for review by the auditor. In this situation, the auditor should consult the audit supervisor for guidance. Also see Title 23 VAC 10-210-693 K.

Field Audit Procedures – Sales & Use Tax



Topic: Forest Products Tax

Revised: December 2012

I. References

- A. Code of Virginia:
58.1-1600 thru 58.1-1622
- B. Public Documents:
PD 95-51
PD 07-167
- C. Returns:
Form 1034 - Forest Products Tax Return
Form 1035 - Forest Products Tax Return (Small Manufacturers and certain Small Severers)

II. General

- A. The Forest Products Tax is a Commodity tax that is imposed on the manufacturer in Virginia who will change the state of the forest product (tree) that was harvested in Virginia into a usable product or the shipper of the forest product that was harvested in Virginia that is shipped out of Virginia.
- B. A **manufacturer** for forest products purpose is the person who operates a sawmill for the sawing of logs into rough lumber and its various sizes and forms, or who operates a cooperage mill, veneer mill, excelsior mill, paper mill, chip mill, chemical plant or other means for the processing of forest products into products other than lumber. For the purpose of this tax, manufacturer also includes the person who purchases from the person who severs cross ties, switch ties, mine ties, mine props and other forest products used in the connection with mining and piles and poles (except fish net poles). Furthermore, a manufacturer includes the **severer** of post, fuel wood, fish net poles and similar products. **A manufacturer for Forest Products Tax might not be the same as a manufacturer for sales tax!**
- C. If the manufacturer, as listed above, is not in Virginia then the tax is payable by the **shipper**. A shipper is any person in this state who sells or ships outside the state by railroad, truck, barge, boat or by any other means of transportation any forest product or products in an unmanufactured condition, whether as an owner, lessee, woodyard operator concessionaire, agent or contractor.
- D. Forest products include logs, timber, pulpwood, excelsior wood, chemical wood, wood chips, bolts, billets, crossties, switch ties, mine ties, poles, piles, fuel wood, post, all cooperage products, tan bark and any and all other types of forest products, except dead chestnut wood.
- E. The Forest Products Tax is not applicable to any forest products harvested outside of Virginia nor on forest products manufactured in Virginia from timber harvested from outside of Virginia.

F. There are two exemptions for Forest Products Tax:

1. Forest products that are cut by an individual owner from their own property for their own use. Own use means in the construction or repair of their structures, buildings or improvements; or for their home consumption (i.e. firewood); or for use by them in processing their farm products.
2. Forest products that are severed and used by the State educational institutions for the experimentation in teaching about forestry if the product is severed from land owned by the state.

G. Every taxpayer that is subject to Forest Products Tax is required to keep their records for three (3) years following the date the tax is reported. The records must separate the forest products into the various categories on which the tax applies. It is a class 4 misdemeanor for any person who fails to file a return, keep the required records or refuse to permit examination of their records.

H. The following are the tax rates for forest products:

Product	Tax Rate	
Pine Lumber (mbm)	1.15\$	per M ft. B.M
Pine Lumber (ton)	0.20\$	per ton
Hdwd Lumber (mbm)	0.225\$	per M ft. B.M.
Hdwd Lumber (ton)	0.04\$	per ton
Pine Logs (bf)	1.15\$	per M ft. Log Scale (Int'l 1/4" Kerf Rule)
Pine Logs (ton)	0.20\$	per ton
Hdwd Logs (mbf)	0.225\$	per M board ft. Log Scale (Int'l 1/4" Kerf Rule)
Hdwd Logs (ton)	0.04\$	per ton
Pine Veneer Logs (bf)	1.15\$	per M board ft. Log Scale (Int'l 1/4" Kerf Rule)
Pine Veneer Logs (ton)	0.20\$	per ton
Hdwd Veneer Logs (mbf)	0.225\$	per M board ft. Log Scale (Int'l 1/4" Kerf Rule)
Hdwd Veneer Logs (ton)	0.04\$	per ton
Pine Pulpwood (cord)	0.475\$	per standard cord of 128 Cu. Ft.
Pine Pulpwood (ton)	0.20\$	per ton
Hdwd Pulpwood (cord)	0.1125\$	per standard cord of 128 Cu. Ft.
Hdwd Pulpwood (ton)	0.04\$	per ton
Pine Railroad Crossties per piece	0.038\$	per piece
Pine Railroad Crossties per ton	0.20\$	per ton
Hdwd Railroad Crossties per piece	0.01\$	per piece
Hdwd Railroad Crossties per ton	0.04\$	per ton
Pine Chip manufactured from roundwood (100 lbs)	0.00986\$	per 100 lbs.

Product	Tax Rate	
Hdwd Chips manufactured from round wood (100 lbs)	0.00234\$	per 100 lbs
Pine Mining posts, ties, props, round mine collars, etc. - 4' length or less	0.38\$	per 100 pieces
Hdwd Mining posts, ties, props, round mine collars, etc. - 4' length or less	0.09\$	per 100 pieces
Pine Mining posts, ties, props, round mine collars, etc. - over 4' but not over 8'	0.6175\$	per 100 pieces
Hdwd Mining posts, ties, props, round mine collars, etc. - over 4' but not over 8'	0.1425\$	per 100 pieces
Pine Mining posts, ties, props, round mine collars, etc. - over 8' (100 pieces)	0.76\$	per 100 pieces
Hdwd Mining posts, ties, props, round mine collars, etc. - over 8'	0.18\$	per 100 pieces
Pine - Taxpayer may elect to pay taxes on products in this item (lineal ft)	1.045\$	per M lineal ft.
Pine - Taxpayer may elect to pay taxes on products in this item (ton)	0.20\$	per ton
Hdwd - Taxpayer may elect to pay taxes on products in this item (lineal ft)	0.2475\$	per M lineal ft.
Hdwd - Taxpayer may elect to pay taxes on products in this item (ton)	0.04\$	per ton
Pine Keg Staves: (400 in bundle)	0.038\$	per standard 400 inch bundle
Pine Keg Staves: (ton)	0.20\$	per ton
Pine Keg Heads: (100 heads)	0.115\$	per 100 heads
Pine Keg Heads: (ton)	0.20\$	per ton
Hdwd Keg Staves: (400 in bundle)	0.015\$	per standard 400 inch bundle
Hdwd Keg Staves: (ton)	0.04\$	per ton
Hdwd Keg Heads: (100 heads)	0.045\$	per 100 heads
Hdwd Keg Heads: (ton)	0.04\$	per ton
Hdwd Tight Cooperage (100 staves)	0.045\$	per 100 staves
Hdwd Tight Cooperage (ton)	0.04\$	per ton
Hdwd Tight Heads (100 heads)	0.09\$	per 100 heads
Hdwd Tight Heads (ton)	0.04\$	per ton
Pine Piling and poles of all types	2.31%	invoice value f.o.b. loading point
Pine Piling and poles of all types	0.20\$	per ton

Product	Tax Rate	
(ton)		
Hdwd Piling and poles of all types	2.31%	invoice value f.o.b. loading point
Hdwd Piling and poles of all types (ton)	0.04\$	per ton
Pine Any other type of forest products not counted above (100 cu ft)	0.71\$	per 100 Cu. Ft.
Hdwd Any other type of forest products not counted above (100 cu ft)	0.135\$	per 100 Cu. Ft.

Any other type of forest product not enumerated above:

The Tax Commissioner shall determine a fair unit tax rate, based on the cubic foot wood volume relationship between the product and the cubic foot volume of 1000 ft board measure of pine when the product is pine or on the unit rate of hardwood lumber when the product is a species other than pine.

Annual Tax for small manufacturers of rough lumber:

300,000 to 500,000 board feet - \$460.00

less than 300,000 board feet - \$230.00

There is a provision for alternative rates. This provision is for use if the General Assembly fails to appropriate from the general fund an amount at least equal to the revenue estimated to be collected from the pine reforestation program.

III. Procedures

A. When doing a sales & use tax audit on a business that sells or buys any of the items listed above the forest products tax may apply.

B. **Some of the businesses that will be subject to the forest products tax:**

Loggers If they sell chips to anyone whether the chips will be used as fuel, landscaping or any other type of use.

If they ship whole logs to anyone outside of Virginia.

If they sell firewood directly to a consumer.

Sawmills If they buy whole logs from a logger or woodyard.

Woodyards they ship any of the whole logs to a concern outside of Virginia.

If they sell chips from a whole tree.

Papermills If they buy the whole logs from the logger or woodyard.

- C. A manufacturer that uses logs as their raw material will be prime candidates for paying the forest products tax. The tax is computed on board feet or on weight, depending on the product, being manufactured or shipped. Most logs are bought by a weight measure. The manufacturer that you are auditing will need to give you the weight for each product being taxed.
- D. Forest products tax is a Quarterly tax. The quarters end on March 31, June 30, September 30 and December 31. The tax is due within 30 days of the end of the quarter. Some small manufacturers can pay an **annual** tax. The tax for these dealers is due within 30 days of the last day of December.
- E. You will need to account for which locality the forest product was manufactured in or shipped out of. At least 50% of the tax collected is returned to the locality from which the tax was collected.
- F. Currently there is no audit report for forest products. When doing an audit you may use the forest products tax return, Form 1034 or 1035, which will calculate the tax due for you. Enter the tax amounts in STAUDN to compute the audit liability. Follow the Siebel and AR Field Audit Procedures for processing miscellaneous tax audits. Penalty may apply but the regulations do allow for the penalty to be waived at the Department of Taxation's discretion.

Field Audit Procedures – Sales & Use Tax



Topic: Harvesting of Forest Products

Revised: December 2012

I. References

- A. Code of Virginia:
58.1-609.2(6)
- B. Virginia Administrative Code:
23 VAC 10-210-700
- C. Public Documents:
PD 99-213
PD 00-54
PD 07-203
PD 09-100
- D. Exemption Certificate:
ST-17

II. General

A harvester's purchase of machinery and tools and their repair parts, fuel, power, energy, or supplies used directly in the harvesting of forest products for sale or for use as a component part of a product to be sold is exempt from the tax.

The term "directly" includes all operations prior to the transport of the harvested product necessary for (i) removing timber or other forest products from the harvesting site, (ii) complying with environmental protection and safety requirements applicable to the harvesting of forest products, (iii) obtaining access to the harvesting site, and (iv) loading cut timber or other forest products onto highway vehicles for transportation to storage or processing facilities

III. Procedures

A. Clearing Activities:

Machinery and tools, etc., used in the clearing of land or construction of roads and trails to a logging site are exempt. Such items include:

- Bulldozers and other equipment used to construct roads and trails.
- Gravel, culverts and similar items used in constructing roads and trails to the harvesting site.
- Temporary bridges, logging mats, and similar items used to provide access to the harvesting site.

B. Severing Activities:

Machinery and tools, etc., used in the severing of trees and in the conveying of severed timber from the logging site are exempt. Such items include:

- Axes, chain saws, saws, shearers, slashers and other equipment used to sever trees.
- Bulldozers, tractors, skidders, cables and other equipment used to pull logs out of the woods.

C. Sorting and Loading Activities:

Machinery and tools, etc., used in loading cut timber or other forest products onto highway vehicles for transportation to storage or processing facilities are exempt. Timber is typically conveyed from the logging site to a nearby log landing where the logs are concentrated, processed, and/or sorted prior to being loaded onto highway vehicles for transport to a log yard (holding yard) or to a mill or other processing facility. Such exempt items include:

- Forklifts, lift trucks and similar equipment used to handle logs at the log landing, and to load logs onto trucks or trailers for transportation to storage or processing facilities.

D. Environmental Protection Activities:

Machinery and tools, etc., used in complying with environmental protection and safety requirements applicable to the harvesting of forest products are exempt. Certain activities are mandated by the Department of Forestry's Best Management Practices to reduce erosion and to prevent or control pollution resulting from forestry operations. Exempt items used in these activities include:

- Equipment and supplies used in construction of erosion control structures at the logging site, on access roads and trails, and at the log landing.
- Equipment and supplies used to stabilize disturbed areas after harvesting operations have ceased.

E. Indirect Activities:

A harvester's purchase of machinery and tools and their repair parts, fuel, power, energy, or supplies used indirectly in the harvesting of forest products is subject to the tax. Indirect activities include the clearing of trash from the harvesting site, the transporting of exempt equipment and supplies to the harvesting site, the transporting of logs to storage or processing facilities, the maintenance of exempt machinery and equipment, and administrative activities. Such items include:

- Cables used to secure logs to a truck for transportation.
- Fuel tanks.
- Repair parts for licensed and unlicensed trucks used for the transport of employees, equipment and supplies.

- Welders and related gases, and other tools and supplies used to repair and/or maintain exempt equipment.
- Repair parts, tires, etc., used on vehicles for transporting lumber from the log landing to storage or processing facilities.
- Equipment and supplies used to tally logs, and for other administrative functions.

F. Dual Use of Equipment:

Equipment and supplies used in both exempt and taxable activities are subject to the tax unless the harvester can substantiate the percentage of use of such items in exempt activities. In such cases the harvester can prorate the tax due on the equipment or supplies based upon the percentage of use of such items in taxable activities.

Field Audit Procedures – Sales & Use Tax



Topic: Medical Facilities/Health Care Providers

Revised: December 2012

I. References

- A. Code of Virginia:
 - 58.1-609.10 (9) (10) (11) (14)
 - 58-1-609.11
- B. Virginia Administrative Code:
 - 23 VAC 10-210-710
 - 23 VAC 10-210-720
 - 23 VAC 10-210-2060
- C. Public Documents:
 - PD 12-95 Documentation required for exempt sale of prosthetic devices
 - PD 11-75 Application of tax to biological soft tissue products
 - PD 10-269 Application of tax to general healthcare/fitness programs
 - PD 10-254 Taxability of custom fitted mouth guards
 - Pd 10-226 Cather systems purchased by licensed physicians are exempt
 - PD 10-179 Taxability of sales made by dental supply businesses
 - PD 08-79 IV therapy operation with pharmacy considered exempt
 - PD 00-89 Taxability of profit home care cooperative formed by nonprofit hospitals
 - PD 96-64 Taxability of dietary/nutritional supplements
- D. Applicable Case Law:
 - Chesapeake Hospital Authority v. Department of Taxation - The nonprofit hospital exemption applies to a nonprofit hospital's purchases of raw food products for preparation by its dietary department for consumption at the hospital facility by medical staff, participants at hospital sponsored meetings and volunteers.
 - Northern Virginia Doctors Hospital v. Department of Taxation - Exemption for drugs sold to a for-profit hospital by a pharmacy upon written order of a physician.
 - Bluefield Sanitarium, Inc. v. Department of Taxation - Taxability of drugs purchased by a for-profit hospital's pharmacy for distribution by work order of physician to patients.
- E. Exemption Certificate - The ST-13 has been revised as of July 2001 and should be used by the specific purchasers listed and for the specific medical items and products listed on the exemption certificate form. The ST-13 should not be used by nonprofit hospitals, nonprofit hospital cooperatives and nonprofit hospital corporations, nonprofit nursing homes, nonprofit adult homes, and other nonprofit medical facilities that are entitled to nonprofit exemptions. These entities are provided an exemption letter by the department, which should be furnished to their vendors to make tax-exempt purchases.

II. General

- A. Effective 7/1/2004, many of the nonprofit medical facilities or medically related companies which were previously taxable, qualify for the new nonprofit exemption, and are therefore exempt on all purchases of tangible personal property.
- B. Hospitals/Nursing homes (profit and not for profit) - Nonprofit hospitals and nonprofit licensed nursing homes, which qualify for the nonprofit exemption and have obtained their nonprofit letter, are exempt on purchases for their own use and consumption. Profit hospitals and nursing homes, however, are taxable on all purchases of tangible personal property (TPP) used or consumed in connection with their operation (except items which specifically qualify for exemption such as durable medical equipment (DME), medicines & drugs). Any divisions making sales must register as a dealer and collect and pay the tax.

Effective 7/1/1998, all purchases of nonprescription and proprietary medicines are exempt regardless of the purchaser.

Effective 7/1/2000, the medicines and drugs exemption was expanded to include medicines and drugs purchased by any licensed hospital. Effective 7/1/2006, the medicines and drug exemption was again expanded to include for-profit nursing homes, clinics and similar corporations.

- C. Hospital Cooperative and Hospital Corporations - Only nonprofit cooperative and hospital corporations which qualify for the nonprofit exemption and have obtained their nonprofit letter are exempt from the tax. All others are taxable.
- D. Clinics - Only nonprofit clinics which qualify for the nonprofit exemption and have obtained their nonprofit letter are exempt. All other clinics are subject to tax except for items exempted under other code sections.
- E. Home for Adults (profit and not for profit) - Only nonprofit homes for adults which qualify for the nonprofit exemption and have obtained their nonprofit letter are exempt. All other homes for the care and maintenance of children, adults and other persons are taxable.
- F. Physicians Offices - Physicians are considered the consumer of all purchases used in providing their medical services. There are three main exceptions to this:

Purchases of controlled drugs and dialysis equipment/ supplies used in their practice, purchases of nonprescription and proprietary medicines and purchases of exempt durable medical equipment when purchased on behalf of a specific patient. Any physician who regularly makes sales of TPP must register as a dealer and collect and pay the tax on retail sales.

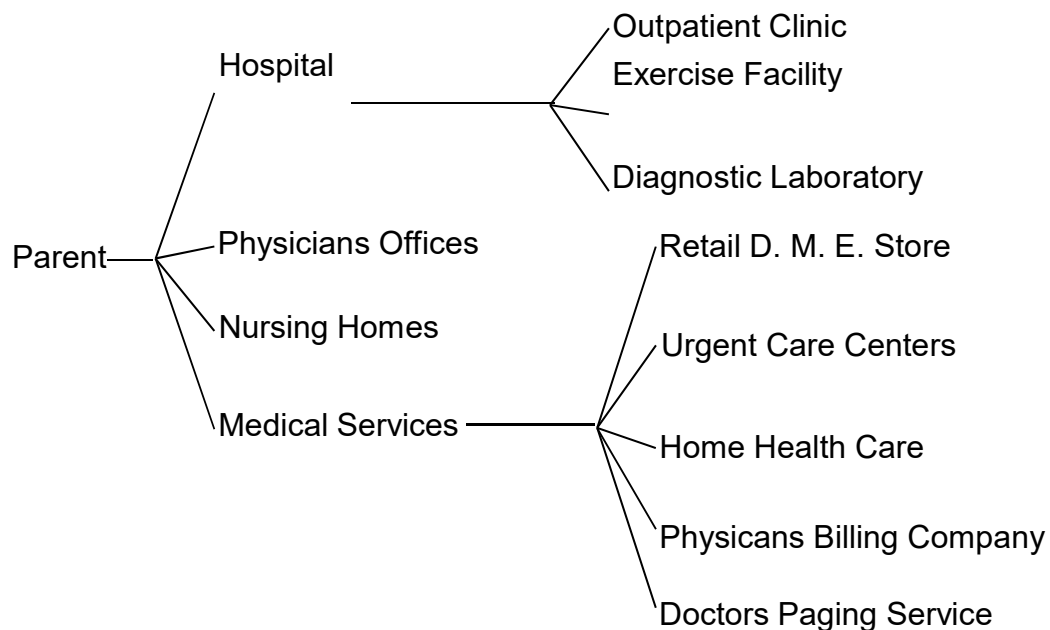
NOTE: All facilities, regardless of the taxability on all other items, may purchase hemodialysis and peritoneal dialysis equipment and supplies exempt of the tax. This does not include general supplies but supplies specifically for dialysis equipment and treatment.

NOTE: Effective 7/1/98 all nonprescription and proprietary medicines are exempt from sales and use tax. "Nonprescription drugs" include

any substance or mixtures of substances containing medicines or drugs for which no prescription is required and which are generally sold for internal or topical use in the cure, mitigation, treatment, or prevention of disease in human beings. "Proprietary medicines" are any nonprescription drug sold to the general public under the brand name or trade name of the manufacturer and does not contain any controlled substance or marijuana. The exemption does not apply to cosmetics.

III. Procedures

- A. **OVERVIEW:** In examining various medical facilities, it is important to understand the changes which have occurred in the last decade in the health care industry. In the past, most health entities were independent medical facilities. With the trend in recent years towards the concept of "Managed Health Care", there are many more multi-level health care corporations involving many types of health care facilities. The following is an organizational chart typical of such an organization:



It is imperative to ascertain whether the entities are profit or nonprofit. A nonprofit entity must have the nonprofit letter issued by the Tax Department in order to qualify for the nonprofit exemption. Health care entities should examine the relationship between their various entities to determine the taxability of each facility and identify possible taxable transactions between them. In addition, the organizational chart, federal tax returns, chart of accounts and general ledgers may provide information to assist the health care entity in determining taxable areas.

- B. Hospitals and Nursing Homes - (Profit and Not for Profit)

Profit - Profit hospitals and profit nursing homes are taxable on all purchases of tangible personal property used in the provision of their medical services. Effective 7/1998 purchases of nonprescription and proprietary medicines are exempt regardless of the purchaser. Effective 7/2000, the exemption for

medicines and drugs was expanded to include purchases by any licensed hospital. Effective 7/1/2006, the medicines and drug exemption was again expanded to include for-profit nursing homes, clinics and similar corporations. The exemptions for durable medical equipment and prosthetic devices still apply for purchases made on behalf of individuals. When any divisions or departments sell TPP, they must register and collect the tax.

One clarification needs to be made regarding the acquisition of blood products from the American Red Cross. This transaction is to be treated as a nontaxable service. The Red Cross obtains the blood from donors, screens the blood and then separates it for distribution to various medical facilities.

Blood, tissue, bones and organs provided by other nonprofit entities, such as a tissue bank, are also considered nontaxable services.

Nonprofit - A non-profit hospital or nursing home which qualifies for the nonprofit exemption and has obtained its nonprofit letter is exempt on all purchases of tangible personal property for use in providing its medical services. Any purchases of controlled drugs are exempt and purchases of DME and prosthetic devices are also exempt whether purchased for a specific patient or in bulk. As with for-profit, any divisions or departments selling TPP must register and collect the tax.

A 2001 court ruling in *Chesapeake Hospital Authority v. Department of Taxation* applies the nonprofit hospital exemption to a nonprofit hospital's purchases of raw food products for preparation by its dietary department for consumption at the hospital facility by medical staff, hospital meeting participants and volunteers. The exemption does not apply to catered meals purchased by a nonprofit hospital from an outside vendor.

It should be noted that external transfers or sales from the hospital or nursing home to other entities (related and non-related) may be taxable as well. If the transfers are to inter-related companies, the transfers are usually handled internally with the transactions posted in the general ledger.

The sale of fixed assets is another area to review for tax compliance. A sale is exempt if it met the "occasional sale rule" of three or less sales per year. With constant changes in technology, many medical facilities are continually updating their equipment. Sometimes, there are sales to related companies, both exempt and taxable.

Another area of possible issues is the sale of TPP. Some departments may go beyond their services to the hospital and make sales to other entities. In addition to services, they could also have sales of printing or audio-visual slides. If this is the case, the hospital's department or division must be registered to collect sales tax. Most likely, the purchases would have been bought exempt under the hospital exemption, so only the sales would have to be examined. This does not negate the exemption for the operating expenses of this department or division of the nonprofit facility.

C. Hospital Cooperatives and Hospital Corporations:

Hospital cooperatives and affiliated corporations must qualify for their own nonprofit exemption and have obtained their nonprofit letter. The fact that an

affiliated parent hospital or parent corporation has such exemption does not extend to other separate yet affiliated cooperatives and corporations.

D. Clinics:

A clinic which qualifies for the nonprofit exemption and has obtained its nonprofit letter is exempt from sales tax. Effective 7/1/2006, the medicines and drug exemption was expanded to include for-profit clinics. For-profit clinics are subject to the tax on all other purchases, unless the items are specifically exempted. A for-profit clinic is eligible for the exemption is when the clinic is an integral part of a nonprofit hospital. The clinic should review the corporate structure, billing practices, and the question of whose credit is bound to assist in determining if it is part of a nonprofit hospital. The physical location of a clinic in relation to its affiliated hospital may be part of the analysis but is not a determining factor.

E. Home for Adults (Profit and Not For Profit):

This exemption applies only to homes licensed as a home for adults by the Virginia Department of Social Services and conducted not for profit (provided they qualify for the nonprofit exemption and have obtained their nonprofit letter). Any home, profit or nonprofit, which is not licensed as noted, and provides the care and maintenance of children or other persons, are taxable on all purchases of tangible personal property. Some retirement communities operate several types of facilities within their organization. Each facility must be properly licensed in order for the exemption to apply.

F. Physicians Offices:

Generally, physicians' offices are considered the consumers of all tangible personal property used in providing their services. There are three main exceptions to this - purchases of controlled drugs and dialysis equipment/supplies used in their practice, purchases of nonprescription and proprietary medicines and purchases of exempt durable medical equipment when purchased on behalf of a specific patient. The physician's exemption for controlled drugs applies regardless of whether the practice is organized as a sole proprietorship, partnership or professional corporation, or any type of corporation in which the shareholders and operators are all licensed physicians engaged in the practice of medicine. The exemption for controlled drugs purchased by a licensed physician in his professional practice also includes optometrists, licensed nurse practitioners, and licensed physician assistants. Physicians may also purchase durable medical equipment or prosthetic devices on behalf of a specific patient. Bulk purchases of DME or similar devices are subject to the tax even if they are later dispensed to, or modified for specific patients.

Physicians who regularly engage in the sale of TPP must register to collect tax. Some physicians, because of their rural location, will obtain a license from the Board of Pharmacy, in effect acting as pharmacists. In cases such as this, the physician may purchase items for resale but must report any use tax on items (except controlled drugs) for use in his professional practice. Also, some dermatologists offer skin care and cosmetic products to their patients. These products are not deemed to be drugs or medicines and the sales are not considered part of their medical services. Therefore, the dermatologist is

operating as a retailer and must register to collect the tax. Another example of taxable sales is the selling of vitamins, minerals or nutritional food supplements in conjunction with a physician's weight loss program.

Field Audit Procedures – Sales & Use Tax



Topic: Hotels, Motels, Tourist Camps, etc.

Revised: September 2016

I. References

- A. Code of Virginia:
 - 58.1-602
 - 58.1-603.4
 - 58.1-609.5(8)
- B. Virginia Administrative Code:
 - 23 VAC 10-210-730
 - 23 VAC 10-210-930
 - 23 VAC 10-210-4040
- C. Public Documents:
 - PD 10-3 Hotel Cancellation Fee is not subject to sales tax.
 - PD 09-179 Diplomatic Exemption Card
 - PD 08-4 Room Accommodation Packages are subject to tax
 - PD 07-34 Communication Sales and Use tax application to hotel transactions

 - PD 04-135 Admission tickets taxability when provided by lodging provider

 - PD 04-68 Hotel Point Redemption Programs
 - PD 03-94 Federal Government Credit Cards
 - PD 02-14 Room & guest amenities are subject to sales tax
 - PD 00-164 Determination of Taxability of Hotel Pay TV
 - PD 99-254 Conference room rentals to churches
 - PD 98-117 Amenities, Complimentary breakfast
 - PD 97-229 Taxability of lodging to Local, State & Federal Governments

 - PD 96-295 Services charged in connection with room rentals
 - PD 94-60 Meals furnished to non-restaurant employees
 - PD 93-167 90-day Rule for Lodging sales tax exemption
 - PD 92-120 Comprehensive List of Transactions Related to Hotels
- D. Exemption Certificates:
 - ST-10 (Resale)
 - ST-12 (Federal Government)

II. General

- A. Code of Virginia defines the terms “retail sale” and a “sale at retail” to include the sale or charges for any room or rooms, lodgings or accommodations furnished to transients for less than 90 continuous days by any hotel, motel, inn, tourist camp, tourist cabin, camping grounds, club, or any other place in

which rooms, lodging, space, or accommodations are regularly furnished to transients for a consideration.

58.1-603.4 imposes the sales tax on the gross proceeds derived from the sale or charges for rooms, lodgings or accommodations furnished to transients as defined above. The tax also applies to sales of tangible personal property (TPP) and other taxable services by such businesses.

- B. "Corporate housing" refers to apartment units in residential apartment buildings that have been furnished and offer a wide range of a la carte furnishings and service options. Guests have the comforts of home in a private residential setting, typically with a 30-day stay.

"Serviced apartments" operate more like a hotel, with onsite hospitality staff, a 24-hour front desk, daily maid service, and offer accommodations for both daily and longer stays.

- C. Accommodations furnished for 90 continuous days. The tax does not apply to rooms, lodgings or accommodations supplied to a guest for a period of 90 continuous days or more. The 90-day continuous stay is not restricted to the same room. After a transient has occupied a room or received other accommodations for 90 continuous days or more, the dealer furnishing the room or other accommodation may refund any sales tax actually collected from the person. In filing a subsequent return with the Department of Taxation, the dealer may deduct from gross sales in the place provided the amount of the charges for which the tax was refunded.

Agreements for the availability of a certain number of accommodations of 90 days continuous days or more are exempt at the time of the agreement.

- D. Charges in connection with accommodations. Any additional charges made in connection with the rental of a room or other lodging or accommodations are deemed to be a part of the charge for the room and are subject to the tax. For example, additional charges for movies, local telephone calls and similar services are subject to the tax.

Charges for television programming by satellite or cable made to hotel customers are exempt provided that the charges are separately stated and title to the receipts vest with the provider (and not the hotel) at all times. In such event, the receipts are not a part of the overall compensation the hotel receives from the rental of the rooms; rather, the hotel is merely the collection agent of the provider.

Hotels that offer "package" stays, which include specified amenities and services in addition to accommodations should tax the total amount paid for the package transaction. A "package" stay may include room, meals, green fees, golf cart, admission tickets, etc. for a single price. Examples of packages may be a Golf package (includes room, meals, and green fee) or an Attraction Admission package (includes room, meals, and tickets to an attraction such as a museum, amusement park or historical site), etc.

- E. Purchases. Purchases of furniture, fixtures, linens, towels, carpeting, drapes, and amenities for use in guestrooms (i.e. toiletries such as soap, shampoo, etc.) are taxable at the time of purchase.

Purchases or rental of audio visual equipment (A/V) for subsequent rental to guests (without an operator) are purchases for resale. The hotel should separately bill for the provision of A/V equipment and collect tax on the charge.

Newspapers and magazines distributed for free, and purchased by subscription directly from the publishers, are not subject to the tax.

- F. Computerized reservation systems. The charge to a hotel, motel or similar business for a computerized reservation system which includes, within a single contract, the provision of a printer or similar hardware and a charge for the use of the system based upon frequency of usage or number of rooms, is deemed to be a service transaction. There is no tax is applicable to charges for such service. The entity providing the service must pay tax on any TPP used in the provision of the service.

III. Procedures

- A. Sales - Exempt sales/charges made by a hotel or motel should be reviewed to confirm their exempt status. In particular, sales to governmental employees or agencies and nonprofit organizations should be examined. State and local governmental agencies or employees are not exempt on their purchases of hotel or motel meals or lodging.

1. Federal Employees are exempt from tax on meals and lodging only under certain circumstances. An exemption is provided for federal government purchases of meals and lodging when they are made pursuant to official purchase orders and a completed Certificate of Exemption Form ST-12 is provided, or with an official government credit card that is billed directly to the Federal Government. Note that the American Red Cross is treated as a federal governmental agency, subject to the same rules as federal agencies and use of the ST-12.

Exempt purchases may be made using Federal Government Credit Cards – General Services Administration (GSA) SmartPay 2 Program cards such as Purchase cards (4275 33), and Corporate cards (4046 58).

Many governmental employees are issued governmental credit cards for travel, but this does not mean they are exempt from meals and lodging. Both taxable and exempt cards will have the names of the individual and the agency they represent. The cards look the same except for the 6th (last digit). Following is a list of taxable and exempt travel cards:

Exempt Credit Cards: (These cards are directly billed to and paid by the federal government.)

- MasterCard prefix 5565 & 5568 with sixth digit being either: 0, 6, 7, 8, or 9.
- Visa prefix 4486, 4614 & 4716 with sixth digit being either: 0, 6, 7, 8, or 9.
- Voyager prefix 8699 with sixth digit being either: 0, 6, 7, 8, or 9.

Taxable Credit Cards: These cards are billed to individual federal employees who make payment for transactions. The employees are

reimbursed for these costs through federal travel expense procedures.

Note: SPLIT DISBURSEMENTS by the Federal government do not change the taxable status of these transactions:

- MasterCard prefix 5565 & 5568 with sixth digit being either: 1, 2, 3 or 4
- Visa prefix 4486, 4614 & 4716 with sixth digit being either: 1, 2, 3 or 4

Note: the type of cards and account numbers may be updated as necessary with government credit card changes.

Cash Transactions or Personal Credit Card: Any transactions or portion thereof paid in cash or with a personal credit card is subject to the sales tax even if the customer is a federal employee or has an exempt credit card but declines to use it.

2. Foreign Diplomats may also be exempt on their purchases of meals and lodgings. The Office of Foreign Missions US Department of State issues credit cards to members of foreign missions. Each card is color-coded with a stripe that distinguishes various levels of exemption. Mission or Personal Tax Exemption Cards with a BLUE stripe at the bottom are exempt from all sales taxes. The hotel/motel should obtain the exemption card number from diplomats, annotate it on the record of the sale, and keep a photocopy of the diplomat's exemption card, if possible. Foreign diplomats who qualify for the exemption on taxable services are exempt when hosting a group of non-diplomats. Also, personal exemption cards may be paid with cash or personal check/credit card and retain their exempt status.
3. Previously, a few nonprofit organizations enjoyed an exemption on taxable services, which exempted them from sales tax on meals and lodging. However, since the changes in the Non Profit Organization exemption, effective July 1, 2004, there are no exemptions for meals or lodging for any nonprofit organization.

The exemptions for nonprofit churches, nonprofit hospitals and nonprofit licensed nursing homes do not specifically exempt "services." Thus the charges for lodging and meals ("taxable services") to these entities are subject to sales tax.

Similarly, the charges for lodging and meals ("taxable services") to nonprofit schools and colleges are subject to sales tax. However, effective October 1, 2008, nonprofit schools may purchase food for free distribution at their facility exempt from the sales tax.

4. Sales price is defined in § 58.1-602 as, "the total amount for which TPP or taxable services are sold and includes any services in connection with such sale." Examples would be: added charges for movies (other than nontaxable programming), telephone charges other than long-distance toll charges, whale watching fees, golf fees etc. if they are sold in connection with the room rental.

Any charge for a local phone call is subject to the sales tax. Toll charges for long-distance telephone calls (without markup) are not subject to the tax. However, additional charges for long-distance telephone calls are subject to the tax.

Digital Media Fee - Pay per-view is an optional service provided through a cable/satellite company for the viewing of a specific movie or event provided to the hotel guests for an additional fee. These fees are collected by the hotel as a separate charge. These "pay per-view" charges are not subject to the tax provided the charges are separately stated and title to the receipts vests with the cable/satellite provider at all times and not the hotel. In this situation, the hotel is the collection agent for the cable/satellite provider. Should the hotel retain a portion of the movie/event receipts (commission), title does not vest completely with the cable/satellite provider and the entire charge would be subject to the tax.

- B. Purchases – Equipment rented by a restaurant for its own use in preparing and serving meals, such as kitchen equipment, tablecloths, and similar items are taxable and may not be purchased under a Certificate of Exemption. Also, the taxpayer should apply tax to the total charge for an event including the cost of labor, equipment, supplies or other services provided in connection with its catering service, whether separately stated or not.

Many hotels and motels use computerized reservation systems. The charge for a computerized reservation system which includes, within a single contract, the provision of hardware and charges for the use of the system is deemed to be a service transaction.

The cost of food for meals furnished to restaurant employees as part of wages is exempt. If meals are provided to restaurant employees which are not part of wages, the use tax is due on the cost of those meals. Meals provided by employers to other than restaurant or food service operation employees are subject to the tax.

Purchases of food and non-alcoholic beverages for the preparation of complimentary breakfasts are not taxable. These items can be purchased with a resale exemption certificate, since the costs of the complimentary services are included in the taxable room rental charges. Purchases of equipment and reusable items would still be subject to the tax.

- C. Corporate Housing/Serviced Apartments - More companies are placing staff and consultants on "short-term assignments," a corporate term for a business trip that is more than one month but does not require relocation. The growth of this form of travel has spurred demand for a new lodging product – corporate housing/serviced apartments.

Hospitality companies may operate in one or more of the following:

1. The company may own an entire apartment community.
2. The company may lease a block of apartments in an established residential apartment community.
3. The company may have an agreement with select residential apartment communities to lease apartments on an "as needed" basis.

The department has previously determined that only a person primarily engaged in the business of “regularly” furnishing accommodations to transients must collect the tax on such occasional rental of an apartment for less than 90 days to represent the “regular” furnishing of transient accommodations. The department has been consistent in not applying the tax to such rentals pending the establishment of definitive policy Procedures.

Field Audit Procedures – Sales & Use Tax



Topic: Computers

Revised: December 2012

I. References

- A. Code of Virginia:
 - 58.1-602 (Definitions)
 - 58.1-609.5(6)(7) (Service Exemptions)
- B. Virginia Administrative Code:
 - 23 VAC 10-210-760 through 766; (Innovative Technology)
- C. Virginia Tax Bulletins:
 - VTB 86-5
 - VTB 95-8
- D. Public Documents:

PD 86-77	PD 86-258	PD 87-88
PD 87-209	PD 88-20	PD 88-211
PD 91-190	PD 91-256	PD 93-237
PD 94-12	PD 94-209	PD 94-251
PD 95-30	PD 95-286	PD 96-14
PD 96-49	PD 96-66	PD 96-193
PD 97-405	PD 98-39	PD 01-61
PD 02-05	PD 01-103	PD 01-149
PD 03-64	PD 04-15	PD 05-12
PD 05-44	PD 05-114	PD 05-134
PD 08-121	PD 08-132	PD 08-134
PD 09-156	PD 12-6	PD 88-159
PD 11-10		
- E. Exemption Certificates: ST-10 (Sales and Use Tax) and ST-11 (Manufacturing)

II. Definitions

- A. A **"custom program or software"** is a computer program that is specifically designed and developed for only one customer.
- B. A **"prewritten program"** is a computer program that is prepared, held, or existing for general or repeated sale or lease, including a computer program developed for in-house use and subsequently sold or leased to unrelated third parties. The combining of two or more prewritten programs does not constitute "custom" software. A prewritten program that is modified to any degree remains a prewritten program and does not become a custom program.

III. General

- A. Generally. The sale, lease, rental, or licensing of **prewritten programs** sold in tangible form is taxable. Custom software programs are specifically excluded in the Code of Virginia from the definition of tangible personal property. As a result, **custom software** is treated as a non-taxable service.
- B. Tangible personal property used in the development of custom software qualifies for the research and development exemption if it is used directly and exclusively in the development of the software. The research and development exemption also applies to the purchase of equipment and supplies used directly and exclusively in developing a prewritten software program.
- C. The production of prewritten software for sale or resale qualifies for the industrial manufacturing exemption. Custom software is not tangible personal property and cannot qualify for the industrial manufacturing exemption.
- D. Separately stated labor or service charges in connection with the modification of prewritten computer software are not taxable. The industrial manufacturing exemption is not available for equipment used to modify prewritten computer software because the processing performed is not industrial in nature.
- E. Additional charges for services such as assembly, configuration, training and travel are taxable when sold in conjunction with tangible personal property, i.e. a complete computer system. The auditor should carefully review the sales contract, (where applicable), to determine what charges are included in the sales price.
- F. The research exemption may be available for tangible personal property used directly and exclusively to modify prewritten software programs to perform new tasks as described in VAC 10-210-3070 to 3074.
- G. Maintenance contracts which include repair parts, upgrades, or updates in the form of tangible personal property are taxable on 50% of the total amount.
- H. Equipment or enabling software purchased or leased for use in a data center is exempt. See Public Document 10-121.

II. Procedures

- A. Computer Hardware: When computer resellers go beyond the configuration and testing of system components (e.g., CPU, monitors, modems, printers) and actually integrate systems (e.g., assembling boards in CPU), they may qualify for the manufacturing exemption as described in VAC 10-210-920.

Computer resellers may purchase equipment for their resale inventory tax exempt using the ST-10. Certain purchases charged to inventory may not be entitled to the resale exemption. Items such as tools, cable affixed to real estate, and similar installation materials are taxable when purchased by the retailer/installer.

- B. Computer Software: Businesses may provide custom, prewritten, and/or modified prewritten software programs.

Custom software is designed and developed for only one customer and is considered a non-taxable service. Sales of additional copies of custom

software are taxable. Custom programs originally developed for in-house use and then marketed for resale become taxable. The auditor should review sales invoices and contracts to determine if the taxpayer is selling additional copies. When conducting audits of custom software developers, the major focus will be on asset acquisitions and expense purchases.

The innovative technology regulation (VAC 10-210-760 through 766) allows for the research and development (R&D) exemption on purchases made for use **directly** and **exclusively** in the development of custom software; such purchases do not qualify for the manufacturing exemption.

Equipment must be used directly and exclusively in R&D (e.g., software used to write new code) to enjoy the exemption. Equipment used to encode the diskette with a program that has already been developed, or hardware used by researchers for use in software development and also for administrative purposes (e.g., word processing) is taxable.

Prewritten ("canned") software is developed for repeated sale or lease and considered taxable. The combining of two or more prewritten programs is not considered custom. Separately stated charges for the modification or alteration of the program are exempt. In addition, separately stated installation charges are also exempt.

Development of prewritten software for sale or resale qualifies for the industrial manufacturing exemption. Tangible personal property used directly in the production of the software can be purchased exempt. However, computer software developed for in-house use is not considered industrial manufacturing.

- C. Delivery of Software: The sale of prewritten software delivered electronically to customers does not constitute the sale of tangible personal property and is, therefore, generally not subject to sales and use taxation.

However, both the vendor and purchaser must retain specific documentation to prove the occurrence of the electronic delivery. At a minimum, a sales invoice, contract or other sales agreement must expressly certify the electronic delivery of the software and that no tangible medium for that software has been or is to be furnished to the customer. A purchase order, e-mail message, or similar request, by itself, presented by the customer is not sufficient to establish that the vendor electronically conveyed the software.

- D. System Sales: If a dealer installs a system and lap links the installation of the software along with the customer receiving tangible copies of the program, then separately stated charges for the program are taxable.

Separately stated labor charges (e.g., system configuration, travel and lodging), with the exception of installation or modification charges are considered part of the "sales price" or "gross proceeds" and are fully taxable.

- E. Training: Charges for training are generally exempt; however, services in connection with a sale of tangible personal property are taxable. For example, a sales agreement for standardized software may include separate invoicing for on-site training, consulting services, and travel time. As part of a sale of tangible personal property, each invoice is taxable. (See PD 96-193)

Businesses conducting training seminars and purchasing training packages frequently pay royalties for training books and software for each customer/student. The business should collect tax on the sales of training materials, if separately stated. If not, the business is considered the consumer of the materials and must remit tax on the purchase price.

- F. Repairs and Maintenance: Computer hardware maintenance and repair is taxable when parts are included. Software maintenance may include upgrades, updates, and support. When upgrades and updates are transferred via diskette or other tangible format, it constitutes the transfer of tangible personal property and is taxable. When upgrades and updates are transferred via modem (electronically), they are not taxable. If a programmer updates/ upgrades a program without any transfer of tangible personal property, the updating/upgrading fee is a non-taxable service.

Computer maintenance, repairs, and support can be invoiced in various formats as follows (non-inclusive):

- Hardware and software maintenance contract – labor only: exempt
- Hardware maintenance contract – parts & labor: 50% taxable
- Hardware maintenance contract – parts only: 100% taxable
- "Time and materials" repair – labor separately stated labor exempt parts taxable
- "Time and materials" repair – labor NOT separately stated: 100% taxable
- Software support which includes updates & upgrades: 50% taxable
- Software "hotline" "helpdesk" phone support only: exempt

- G. Licensing Agreements: The licensing of prewritten computer software constitutes a taxable sale or lease when the licensing agreement conveys not only the right to use computer software but also the software itself in tangible form. A license agreement that includes a software program and related documentation is subject to the tax. In addition, license fees and charges for source coding the software are taxable.

When a computer reseller purchases a software license and resells copies, consumer use tax is due on the original license fee as it is not being resold. The dealer must collect tax on the sale of the copies delivered on tangible media.

- H. Additional Information: Database on-line services are non-taxable. Firms offering electronic mail and internet access are also offering a non-taxable service and are considered the consumer of all tangible personal property purchased in performing these services.

Firms performing data conversion from one format to another on tangible media are making taxable retail sales. The auditor must apply the "true object" test to determine if the customer wants to obtain tangible property or the company's services.

Field Audit Procedures – Sales & Use Tax



Topic: Leases or Rentals

Revised: December 2012

I. References

- A. Code of Virginia:
 - 58.1-602
 - 58.1 603(2)
 - 58.1 609.6(6)
 - 58.1 609.10(3)
- B. Virginia Administrative Code:
 - 23 VAC 10-210-840
- C. Virginia Tax Bulletin:
 - VTB 95-7
- D. Public Documents:

PD 95-189	PD 95-47	PD 95-246
PD 95-223	PD 87-241	PD89-139
PD 91-182	PD 91-190	PD 94-90
PD 91-266	PD96-66	PD 01-42
PD 01-105	PD 04-194	PD 08-128
PD 11-86	PD 11-118	
- E. Exemption Certificate
 - ST-10

II. General

- A. Code of Virginia § 58.1-603(2) imposes the retail sales tax on every person who leases or rents tangible personal property in Virginia. The sales tax is a “moment of transaction” tax and is imposed upon the gross proceeds derived from the lease or rental of tangible personal property.
- B. A person engaged in the business of leasing or renting tangible personal property to others is required to register as a dealer and collect and pay the tax on gross proceeds.
- C. Tangible personal property for future use by a person for taxable lease or rental may be purchased tax-exempt under a certificate of exemption ST-10.
- D. The term "lease" or "rental" does not include the leasing, renting or licensing of copyright audio or video tapes and films for public exhibition at motion picture theatres or by licensed radio and television stations.
- E. Conditional and installment sales, including those requiring down payments, are considered sales at retail, and as such should be taxed at the initial point of sale and not considered leases or rentals. Finance, carrying and service charges, or interest from credit extended on sales of tangible or personal property under conditional sale contracts or other conditional contracts

providing for deferred payments of the purchase price, are excluded from the definition of sales price. Such charges are not subject to the sales tax, when separately stated.

III. Definitions

- A. Conditional Sales contracts – An agreement whereby possession of an item of tangible personal property passes immediately to the purchaser upon consummation of the contract and title passes to the buyer automatically upon completion of the contract terms. Conditional sales contracts are treated in the same manner as the sale of any other tangible personal property.
- B. Lease – An agreement whereby the use of an item of tangible personal property is passed to a lessee for a fixed period of time with regular payments due during the agreed period. Sales tax is due on each payment during the term of the lease. Title does not pass to the lessee at the conclusion of the agreement.
- C. Lease with Buyout Option – An agreement similar to the lease agreement defined above, with the exception that at the end of the lease period, the lessee is given an option to purchase the item for some consideration. Sales tax is due on each payment during the term of the lease, and on the consideration paid at the end of the lease. Title does not transfer until such time as the purchase option is consummated.
- D. Purchase-leaseback – A transactions in which the lessee purchases tangible personal property for immediate sale to a lessor, and subsequently enters into an agreement to lease the property. If the lessee uses the property prior to selling it to the lessor, the lessee owes tax on the purchase price of the property, and on the subsequent rental charges.
- E. Rental - An agreement whereby the use of an item of tangible personal property is passed to a renter for an indeterminate period of time with a payment or payments due for such use. Sales tax is due on any and all payments made during the period of possession by the renter.

IV. Procedures

- A. Untaxed Sales:
 - 1. Exempt customer – The customer may be coded as tax-exempt. Review the exemption certificate carefully to determine that it is a valid Certificate.
 - 2. Exempt transactions:
 - a) The taxpayer may treat the contract as a financing agreement, or some type of conditional or installment sale, and collected the tax on the sales price of the tangible personal property. If title to the property automatically passes to the “lessee” at the end of the agreement, then no tax is due on the monthly payments. If, at the end of the agreement, possession returns to the “lessor,” or the “lessee” has an option to purchase the property, even for a

nominal amount, the transaction is a lease, and tax is due on the monthly payments.

If the contract is a lease and tax was paid by the lessee at the inception of the lease on the total lease amount, no tax is due on the monthly payments. Sales tax is due on additional taxable charges, such as late fees, not accounted for in the original calculation of the total lease amount. Also, if the sales tax rate increases during the term of the lease, the additional tax is due for the remainder of the lease.

If tax was paid at the inception of the lease on only the purchase price of the property, then tax is due on the difference between the total lease amount and the purchase price.

b) The property/equipment is leased with an operator: Such transactions are not subject to sales tax. However, there are distinctions between an “operator” and an “assistant” or an “attendant” furnished with the rental of equipment. Someone who assists the lessee in the operation of the rented equipment is not an “operator”. Nor is an “attendant” who sets up and takes down the equipment and primarily monitors the operation and use of the equipment.

c) Real property leases which also include the rental of tangible personal property. The portion of the lease payment attributable to tangible personal property is taxable. If the taxpayer cannot determine the taxable portion of the lease payment, tax can be collected on 28% of a lease payment.

d) Transactions which involve the rendering of a service and in connection therewith, the lease of tangible personal property, may qualify as an exempt service transaction. These must be reviewed to determine their “true object.”

e) Computer software licensing fees are taxable, unless the software is delivered electronically.

B. Un-taxed charges – Sales tax is due on the gross proceeds from the lease or rental of tangible personal property

Gross proceeds means the charges made or voluntary contributions received for the lease or rental of tangible personal property. It also includes any service charges in connection with the lease of the property. Such charges include:

1. Finance and interest charges.
2. Insurance charges
3. Assembly and disassembly charges.
4. Fees to pick up lease payments.
5. Damage waivers
6. Charges for parts used to repair leased equipment when the repair is

performed by the lessor and billed to the lessee. This also includes mileage and trip charges.

7. Pumping service charges billed in connection with the rental of portable toilets

C. Wrong state's tax collected:

In the case of rentals transported between states, each monthly invoice is treated as a separate rental and subject to taxation by the state in which the property is located. Thus, Virginia tax should be collected on monthly rental charges subsequent to the rented property being transferred to Virginia.

However, if the state in which the customer takes possession of the rented property treats the rental period as a continuous period – without interruption from initial possession to return of the property – then the other state's tax is properly collected.

Field Audit Procedures – Sales & Use Tax

Topic: Convenience Stores: Inadequate Records/Purchase & Sales Mark-Up

Revised: September 2016

I. References

- A. Virginia Administrative Code:
 - 23 VAC 10-210-340 (Collection of the tax by dealers)
 - 23 VAC 10-210-840 (Rentals)
- B. Virginia Tax Bulletins:
 - VTB 98-4 (Nonprescription Drugs)
 - VTB 05-78 (Food Tax Rate Reduction)
- C. Public Documents:
 - PD 00-46, PD 99-28, PD 97-303, PD 97-298, PD 95-320, PD 94-213 (Purchase Mark-up)
 - PD 10-284 (Prepaid Wireless E-911 Fee)
 - PD 14-19 (Prepaid Telephone Access Cards)
 - PD 99-22, PD 98-72 (Sales Mark-up)
 - PD 99-22, PD 84-89 (Rentals)
 - PD 91-166 (ATM Machines)
 - PD 91-98 (Tanning Bed Rentals)
 - PD 04-27 (Car Wash System)
 - PD 91-48 (Meals Provided Free to Employees)

II. General

Because of the wide variety of items sold at a convenience store, these audits present a challenge. Pre-audit activities are important to get a knowledge of the operations. The dealer may be on a commission basis for gasoline, newspaper sales, and vending machines. Some departmentalized areas such as books and magazines or hardware may be on a consignment basis.

It is characteristic of convenience stores to make purchases such as bread, milk, snacks, etc. from the cash drawer. Some convenience stores are on a program with a convenience store specialty supplier for their grocery purchases. Grocery items may be pre-priced when they are delivered. A convenience store may purchase some items from chain grocery stores when they run specials for resale at their "convenience" pricing.

Most convenience stores sell lottery products. Usually, there is a separate cash register for lottery and a separate bank account from which drafts are made in payment of lottery purchases. Lottery sales may or may not be included in gross sales on the sales tax return.

Most convenience stores now serve prepared food and prepackaged foods as well. Be aware of the Food Tax Reduction Program which may affect how sales are

reported. Reference: Tax Bulletin 99-11, Question and Answer Summary-Food Reduction Program.

Video rentals and tanning bed rentals are also seen occasionally at convenience stores. There are also a growing number of convenience stores with ATM's located in the store.

III. Procedures

- A. Areas of Consideration - A comparative review of sales reported by year and an analysis of the income tax returns are very advantageous in determining potential audit issues. Compare the figures reported on the sales tax returns with the income tax return and note any differences. Use these differences to compare lottery and gasoline sales to Department of Lottery records and records that the taxpayer may have. Does the income tax return show a loss or profit? If the return shows a loss, how did the taxpayer live?

Determining the Percentage of Markup will give a possible indication that either cost of goods is overstated or sales are understated. A tendency to understate sales rather than overstate costs is usually encountered.

Computing the Percentage of Markup is a good way to determine if an audit will be productive. Using the income tax returns, compute the Percentage of Markup for each potential audit year in the following manner:

$$\frac{\text{Gross Sales} - \text{Cost of Goods Sold}}{\text{Cost of Goods Sold}} = \text{Percentage of Markup}$$

Example: Gross Sales of \$19,645.44 with a Cost of Goods Sold of \$15,348.00 equals 28% (.28) markup.

How does each year compare with the other? Care must be taken to observe whether supplies are included in Cost of Goods Sold or separately claimed as operating expenses as this may affect the markup percentage. Our experience has shown that the Percentage of Markup for convenience stores after allowance for theft is generally above 25%. Use this percentage as a guideline when figuring the markup on the face of the income tax return. If the percentages are below this range, chances are that an audit is warranted.

- B. The Initial Interview - The initial interview is important in determining how you proceed with the audit. Conduct the initial interview with the owner. If the owner does not work in the store, the manager, or person who is responsible for the day to day management of the store should also be interviewed. Ensure that questions are specifically stated and geared directly toward the taxpayer's situation. It is a good practice to pre-plan your questions prior to your meeting with the taxpayer. Allow for expected and unexpected responses. Ask open-ended questions, requiring a response other than yes or no, to allow the taxpayer an opportunity to respond to the questions, and allow you an opportunity for follow-up questions or responses. Document taxpayer responses accurately in your workpapers. Have the taxpayer sign a copy of your questionnaire that he did respond in the manner that you recorded. It is important to tie down all known sources of income during the initial interview.

Ask the taxpayer what his percentage of markup is. Ask what items he sells the most. Does the taxpayer accept food stamps? What portion of his sales does he believe are attributable to food stamps? How are inventories valued? If there is a deli in the store, ask how selling prices are determined. What does he think the markup is on the deli? Deli markup can be as much as 200% and is most always 100% and greater. Agree upon a reasonable percentage of markup for the deli. Ask about whether deli supplies are taken from the store inventory and how deli sales are handled (remember there may be a local food tax issue in addition to the reduction of state sales tax issue).

After the initial interview, complete your unit price schedule. Walk around the store, recording the selling price of a sampling of items from the various departments. Convenience stores usually sell more cigarettes, beer, and soft drinks, so be sure to get unit prices of most brands in these categories.

- C. Reviewing the Records - Many small businesses use a single entry bookkeeping system. This system may consist of a ledger, journal, and cash book or only a cash book. If the taxpayer has this sort of books, you will need to examine purchase invoices, bills, receipts and cash register tapes.

Among the items that should be requested from the taxpayer are purchase invoices received from his suppliers, and cash tickets for purchases paid for by cash. Prepare a spreadsheet for each year showing vendor by month. Scheduling a year's purchases on a spreadsheet will allow you to spot any "holes" in the purchase pattern. As you schedule the invoices, notice how often the beer vendor, bread vendor, grocery vendor, etc. service the store. This will also assist you in determining if you have all the invoices. If there are missing purchases, contact the vendor to get their accounts receivable history on the taxpayer. Make a separate schedule for deli purchases as the markup for deli is much higher than the rest of the store.

Note that many suppliers who specialize in convenience stores show the markup on their invoices. As you examine these invoices look for any equipment purchases or supply purchases which may have been made from these suppliers. In examining the overall purchase invoices, you may also find items purchased for the taxpayer's own use which have been included in the records of the business.

Use invoices within the past one or two months to complete your unit price list cost side. This will pair the sales/cost prices. Figure the markup percentage on each item and average overall markup. How does this compare with the analysis of the income tax return and the percentage the taxpayer gave you?

As a cross check, examine cash register tapes. Look for suspicious "Voids" and "No Sale" rings. One experience with a taxpayer showed as many as fifty "No Sale" rings per day. His explanation of "keeping the keys in the cash register" didn't pan out when it was found that his markup percentage was less than 15%.

A bank deposit analysis may also be helpful. Sales of equipment or other fixed assets which may be taxable may be uncovered in this analysis. Compare bank deposits (allow for deposits in transit) plus cash paid outs to sales reported; and with your calculation of marked up sales.

- D. Making the Adjustment - Once you feel you have all the purchases and have determined a reasonable overall average markup, you can use your purchase schedules to compute taxable sales. Add to the purchases from your purchase schedules, the beginning inventory at cost and subtract ending inventory at cost. The result is cost of goods sold for the year. Inventories are shown on the income tax return in the cost of goods sold section.

You can use the overall average markup percentage to mark up the purchases; or mark them up by category. For example, if your purchase spreadsheet shows the purchases are heavily weighted toward beer and cigarettes, you may use an average of all the beer markup percentages for beer purchases; an average of all the cigarette markup percentages for the cigarette purchases; and the remaining overall average on the balance of purchases. An example using overall markup percentage to mark up the purchases is as follows: Purchases totaling \$15,348.00 marked up 28% (.28) would equal sales of \$19,645.44. Computation would be $\$15,348.00 \times 1.28 = \$19,645.44$.

Be sure to make an allowance for theft. One to three percent of purchases is usually adequate depending on store size. If the taxpayer says he has had break-ins, he should have a copy of a police report as documentation. Show these adjustments as a reduction of cost of goods sold on your working papers. Also ask about withdrawals from inventory for his own use which would be taxable at cost.

Mark up the deli purchases using the markup you agreed upon with the taxpayer. If deli purchases are withdrawn from inventory, you must agree on an amount with the taxpayer and then mark it up.

Enter the difference between your marked up purchase schedules and taxable sales reported on the return by month. Remember to include other taxable sales such as video rentals.

Penalty would apply for sales tax collected but not remitted.

- E. Sales Markup - Occasionally, when comparing income tax returns to sales tax returns, the sales reported on the income tax return is greater than reported on the sales tax return. After an analysis to determine if there were commissions or other income included in the sales which should be separated, a sales markup may be done.

The difference between the income tax return sales and sales tax return sales may be spread evenly throughout the twelve months; or allocated by month based on your analysis.

Penalty would apply for sales tax collected but not remitted.

In an instance where the sales tax return sales are greater than the income tax return sales, an adjustment to the income tax return would be warranted if no explanation can be given.

Field Audit Procedures – Sales & Use Tax



Topic: Manufacturing and Fabricating

Revised: September 2016

I. References

- A. Code of Virginia:
 - 58.1-602
 - 58.1-609.3(2)(5)(8)(9)(14)(15)
 - 58.1-609.10(19)
 - 58.1-3660
- B. Virginia Administrative Code:
 - 23 VAC 10-210-920
 - 23 VAC 10-210-560
- C. Public Documents:
 - PD 82-156 Fire Protection/prevent
 - PD 83-51 Boiler chemicals
 - PD 85- 201 Production forms
 - PD 86-46 Ex prod forms, monitors
 - PD 86-98 Packaging-containers
 - PD 87-167 Production records
 - PD 87-274 Repackaging
 - PD 88-17 Cad/Cam-computers
 - PD 88-127 Inventory withdrawals
 - PD 90-15 Swatch cards
 - PD 91-183 Steel, platforms, etc
 - PD 91-291 Cad/Cam-computers
 - PD 92-65 Maint gen & exempt
 - PD 92-189 Boilers/air handling
 - PD 93-135 Quality control
 - PD 93-238 Cooling tower chemicals
 - PD 94-276 Truck/pit scales
 - PD 95-43 Steel, platforms, etc
 - PD 95-140 Storage tanks
 - PD 95-278 HVAC equipment
 - PD 07-193 Fabrication
 - PD 09-15 Fabrication
 - PD 10-244 Quality Control
 - PD 11-35 Countertops Fabrication
 - PD 11-135 Paint Spray Booths
 - PD 11-142 Product Testing Equipment
 - PD 12-1 Mobile Processing Equipment
 - PD 12-118 Manufacturing Software
 - PD 12-119 Industrial in Nature Test
 - PD 12-125 Microbrewery – Industrial in Nature

- D. Exemption Certificates:
 - ST-11
 - ST-11a

II. Definitions

- A. **TPP**-Tangible personal property.
- B. **NAICS** - North American Industry Classification System These business codes are useful to help determine if a particular business activity is deemed to be industrial in nature and entitled to the processing exemption. The use of NAICS codes replaced the use of the SIC Manual referenced in the definition of "industrial in nature" in Virginia Code § 58.1-602. NAICS manufacturing codes begin with the numbers 31-33.
- C. **Manufacturing** - Manufacturing, processing, refining, or conversion includes the production line of the plant starting with the handling and storage of raw materials at the plant site and continuing through the last step of production where the product is finished or completed for sale and conveyed to a warehouse at the production site, and also includes equipment and supplies used for production line testing and quality control.
- D. **Fabrication** - An operation which changes the form or state of TPP is fabrication. Fabrication is distinguished from repair which is an operation that *restores* a used or worn piece of TPP. TPP that is cut, sawed, shaped, bent, threaded, welded, bored, drilled, punched, machined, sheared, or otherwise subjected to an operation which changes the property's form or state is considered to have been "fabricated".
- E. **Fabricator's Production Exemptions** - Fabricators of TPP may take the status of industrial manufacturers when they fabricate TPP for sale or resale. The production exemptions are not available to a fabricator of TPP who fabricates for his own use or consumption (as a contractor or otherwise) and not for sale or resale. However, a fabricator whose principal or primary business is the fabrication of TPP for sale or resale, and who, as a lesser or minor part of this business, fabricates for his own use and consumption, still qualifies for the production exemptions. For example, a paving contractor who primarily manufactures pavement for their own use or consumption in real property construction contracts (furnish and install) is not entitled to the manufacturing exemptions. However, a taxpayer who fabricates pavement primarily for resale would qualify for the manufacturing exemption.
- F. **Administration** - this is the managerial, sales, and nonoperational aspects of manufacturing and processing and includes management, selling and marketing, employee comfort and convenience, and record keeping. Tangible personal property used in administration is subject to the tax.
- G. **Production** - The production line of the plant starting with the handling and storage of raw materials at the plant site and continuing through the last step of production where the product is finished or completed and conveyed to a warehouse at the production site, and also includes equipment and supplies used for production line testing and quality control.

- H. **Distribution** - Distribution is the transport or conveyance of products after the completion of production and is not part of manufacturing or processing. Distribution includes the storage of a product subsequent to its production () and the actual transport of the product for sale. All tangible personal property used to convey, transport, handle, store, market or display finished products is taxable.
- I. **Quality control (QC)** – Some industries may use different terminology such as quality assurance (QA) to denote this function. Generally, QC is limited to production line testing and must occur during the actual production process (see PD 10-244). Thus to qualify for exemption the TPP used in QC must be an “immediate” part of the production process. Activities that occur before, after, or in between production runs do not generally qualify for the QC exemption. Off-site testing or testing of finished products in the warehouse would not qualify for the exemption. Testing or monitoring of manufacturing equipment is not considered an exempt activity.
- J. **Research and development** - The tax does not apply to tangible personal property purchased or leased and used directly and exclusively for research in the experimental or laboratory sense. Research and development must have as its ultimate goal: (i) the development of new products; (ii) the improvement of existing products; or (iii) the development of new uses for existing products. Research and development does not include the modification of a product merely to meet customer specifications unless the modification is carried out under experimental or laboratory conditions in order to improve the product generally or develop a new use for the product. Additionally, research does not include environmental analysis, testing of samples for chemical or other content, operations research, feasibility studies, efficiency surveys, management studies, consumer surveys, economic surveys, research in the social sciences, metaphysical studies, advertising, promotions, or research in connection with literary, historical, or similar projects.
- K. **Preponderance** - When a single item of tangible personal property is put to use in two different activities, one of which is an immediate part of the industrial production process (exempt) and the other of which is not (taxable), the sales and use tax shall apply in full when the preponderance of the item's use (fifty percent or more) is in non-exempt activities. Likewise, the item will be totally exempt from tax if the preponderance of its use is in exempt production activities. For example, a forklift used 51% of the time for handling raw materials would be completely exempt even though it might be used 49% of the time for taxable maintenance or distribution activities. Generally, preponderance only applies to identifiable single items of machinery, equipment or repair parts. Items which are not singular in nature such as bulk purchases of safety apparel, or fuel used in processing as well as for heating, are not considered for preponderance of use. Purchases of these types of items should be taxed on the percentage of their taxable use.
- L. **Plant site** - The exemption is limited to the particular singular plant location in a specific geographic location. The Tax Commissioner has ruled that separately housed production facilities located on the same tract of land also constitutes a single plant site (see PD 03-80). Tangible personal property used in activities conducted away from the plant site or used to convey

products or materials between two plant sites is deemed not to be used directly in manufacturing or processing.

- M. **Stores and/or stores accounts** - Generally, manufacturers physically warehouse (store) at the plant site repair parts (spares), small tools, maintenance and housekeeping supplies. For cost accounting purposes these items are charged to suspense or prepaid expense accounts. When the items are withdrawn from stores the appropriate account or cost center is charged with the cost of the items withdrawn. This account must be carefully analyzed to determine if the sales tax or the use tax accrued is accounted for correctly.
- N. **Pollution control** - The tax does not apply to pollution control equipment and facilities that have been certified to the Department of Taxation as having been constructed, reconstructed, erected or acquired for the abatement or control of water or air pollution. "Pollution control equipment and facilities" means any real or tangible personal property, equipment, facilities or devices used primarily for the purpose of abating or preventing air or water pollution in Virginia. The exemption is not applicable until the property for which such exemption is sought has been certified by the State Water Control Board or State Air Pollution Control Board (DEQ) as used primarily for abating or preventing pollution. Once such certification is obtained, exemption certificates will be mailed automatically to the person obtaining the certification.
- O. **Used directly** - The term "used directly" refers to those activities that are an integral part of the production of a product, including all steps of an integrated manufacturing process, but not including incidental activities such as general maintenance, management, and administration. In order for property to be used directly, it must be indispensable to the actual production of products for sale and it must be an *immediate* part of the production process.

III. General

Industrial manufacturers are usually described as plants, factories or mills and characteristically use power driven machines and materials handling equipment. The production activities of such establishments are usually carried on for the wholesale market or to order for industrial users, rather than for direct sale to domestic consumers.

For a business to obtain the processing exemption it first must be manufacturing or processing products for sale or resale and, secondly, such production must be industrial in nature.

Establishments which manufacture or process tangible personal property as an incidental part of a retail or service business are generally deemed to be engaged in nonindustrial activities. Establishments of this type include retailers such as restaurants, caterers, meat and fish markets, and candy, nut, and confectionery stores which process food products primarily for direct sale on the premises to consumers. Such non-industrial establishments also include individuals engaged primarily in providing personal services such as photographers, artists, tailors, and seamstresses.

The production exemption for fabricators and industrial manufacturers is broad and complex. Items of TPP which are used directly in manufacturing and processing are raw materials, machinery, machinery repair parts, tools, fuel, power, energy, or supplies which are indispensable to the actual production and which are used as an immediate part of such production process. There is also an exemption for safety apparel furnished gratuitously to production line employees. Keep in mind that not all machinery and tools owned by a manufacturer are deemed to be "used directly" in the manufacturing process – especially maintenance equipment and tools. For example, a calibration tool used to maintain exempt production equipment does not qualify for the manufacturing exemption. Also, a ladder used by production line employees to access production equipment would not qualify for the exemption.

The concept of the integrated manufacturing process also includes subprocessing activities which produce TPP used directly in the main manufacturing or processing activity. For example, machinery used to make repair parts for exempt production equipment would also qualify for the manufacturing exemption.

IV. Procedures

- A. Fabricators and manufacturers are a diverse group. The items produced and the processes involved vary from one manufacturer to another. There is no set way to audit a manufacturer. The auditor and audit methods utilized must be flexible. Generally the auditor will look at the following areas (this list is not all inclusive): sales, expensed purchases, fixed assets, stores, withdrawals from inventory, and intercompany accounts.

Several things should be done before the auditor begins to examine specific records at the audit site. The auditor should meet with the taxpayer's representative in order to ascertain exactly what is manufactured. A tour of the plant site should be scheduled so that the auditor has an idea of processes involved and the equipment used.

It should be determined that all the records necessary for the audit are available at the audit site. Inquiries should be made to determine that all purchasing functions for the audit site will be reviewed. Be on the lookout for purchases made by out-of-state corporate headquarters for a Virginia plant site. Ask for general ledgers to check for journal entries used to record purchases and intercompany transfers. Be aware that taxpayers could be making payments by electronic transfer which does not require paper invoicing. Also be aware that manual checks may be utilized for payment of some types of transactions. Purchase orders and the voucher register (if applicable) should be reviewed to determine if all purchase records are seen by the auditor.

A chart of accounts or general ledger with a brief explanation should be used to help determine the taxability of audit exceptions. For fixed assets, work in process, or capital projects, and a list of open and closed jobs for the audit period should be obtained from the taxpayer.

The taxpayer's accrual system for use tax should be reviewed. If the taxpayer files a sales tax return or a direct pay return, these should be examined for correctness.

- B. **Administration** - Administration is the managerial, sales, and nonoperational aspects of manufacturing and processing operations. TPP used in administrative activities are subject to the tax. Following are various items found when auditing manufacturers:
1. Production records are taxable to a manufacturer. Recording charts and recording equipment which are used to generate production data from production equipment are taxable. Computer hardware and software in the manufacturing area that record production information are also taxable. (See PDs 86-46 & 87-167)
 2. TPP withdrawn from a non taxed inventory and given away is taxable at the fabricated cost of the material. Textile manufacturers are a good example. They withdraw material to make swatches, send various lengths of material to prospective customers at no charge and also give completed garments to various charities. (See PD 88-127)
 3. Catalogs and other printed material used to advertise TPP for sale and distributed within Virginia are taxable. Catalogs and other printed materials distributed outside Virginia within a 12 month period are exempt. Items in the "other printed material" category such as annual reports usually will have a higher percentage of distribution in Virginia than catalogs. Rulers, mugs or other similar items are not considered printed material and are taxable. (See PD 90-15)
 4. Swatches and swatch cards are taxable when used as sales aids and are not given the same exemption as catalogs. (See PD 90-15)
- C. **Production** - Production includes the production line of the plant starting with the handling and storage of raw materials at the plant site and continuing through the last step of production where the product is finished or completed for sale and conveyed to a warehouse at the plant site. Following are various items found when auditing manufacturers:
1. Boiler and cooling tower chemicals used to prevent pipe and equipment corrosion and plant growth are taxable as part of general maintenance. The chemicals are not used directly in manufacturing, but are used in preventative maintenance of production machinery. (See PDs 83-51 & 93-238)
 2. Structural steel used for platforms and equipment supports is taxable unless the steel becomes a component part of exempt production machinery and does not become permanently affixed to realty. When freestanding steel legs or other supporting structures are attached to exempt machinery and used solely to support exempt machinery, and the machinery cannot be operated without such supports, then the steel is exempt from the sales tax. (See PDs 91-183 & 95-43)

3. Computer hardware and software used both in taxable and exempt manners are taxed based on their preponderance of use. (See PD 90-15)
4. Packaging materials and shipping containers are exempt whether returnable or nonreturnable when used or consumed by an industrial manufacturer or processor of products for sale or resale. Any packaging or shipping container that restrains movement of the product in more than one plane is considered packaging. (See PD 86-98)
5. Bar coding equipment when used for administrative or inventory control purposes is taxable. However, when bar coding equipment is used directly in the production process it is exempt.
6. Storage tanks used to store fuel are taxable. However, storage tanks used to store raw materials are exempt. (See PD 95-140)
7. Boilers, chillers, air handling units and cooling towers used for employee comfort are taxable when purchased by the manufacturer or a contractor. The same equipment would be exempt to the manufacturer or contractor, with the use of a ST 11-A, when the equipment maintains critical temperature and humidity for the quality of the product being manufactured. (See PD 92-189)
8. Air conditioning equipment used to cool manufacturing machinery is taxable. (See PD 95-278)
9. Cleaning supplies used in general maintenance are taxable. However, cleaning supplies used to ensure the quality of the product are exempt. (See PD 92-65)
10. CAD/CAM computers used for design or redesign purposes are taxable. Those used to produce software which operates manufacturing machinery is tax exempt. (See PDs 88-17 & 91-291)
11. Hoods used to remove fumes for employee comfort are taxable. (See PD 87-277)
12. Fire prevention equipment attached to manufacturing equipment is taxable. (See PD 82-156)
13. Printed forms used directly in the production process are exempt. Any form retained for production records is taxable. If the form is a multi-part form, it may be a percentage taxable item. (See PD 85-201)
14. Computers used to monitor production equipment but don't control the equipment are taxable. Computers used to record manufacturing information are taxable. Computers used to monitor the product for quality purposes are exempt. (See PD 86-46)
15. Electrical items, where more than 50% of the electricity passing through them is going to manufacturing equipment, are exempt. Where electrical items are purchased and placed into stock, a percentage of the stock items should be taxed.
16. Steam, air, or other process piping used more than 51% for processes directly in manufacturing are exempt. When these same items are

purchased and placed into stock, a percentage of the stock items should be taxed.

17. Pit truck scales are deemed to be real property and the tax should be paid by the contractor installing them. (See PD 94-276) Other scales located in the plant may be taxable or exempt based on their use. A postage scale would be taxable. Scales used to weigh raw materials being measured for manufacturing purposes would be exempt.
18. Certified pollution control equipment and facilities are exempt. However, all such equipment is taxable until it has been certified. In performing audits, you must hold this equipment taxable until the dealer has obtained the proper certification.
19. Repackaging is industrial in nature when the packing operation substantially increases the marketability of the product being packaged. Any TPP used directly in the repackaging process would be exempt. (See PD 87-274)
20. Purging compounds used to remove resin from a previous production run from the injection lines of exempt machinery are taxable as supplies used for general maintenance. The compounds are used before and after, but not during, the actual production process. (See PD 10-244)
21. Catwalks, mezzanines and other platforms or devices that provide convenient access to production machinery do not constitute an integral part of production. Although the platforms may be essential to the manufacturing operation, they are not an immediate part of the actual production. Accordingly, steel used to make such platforms is taxable. (See PD 10-159)
22. Charges for tooling, machinery, or equipment (including dies, molds and patterns) where title is transferred by a manufacturer to its customer after use by the manufacturer directly in the production of a product for the customer is exempt. (See PD 00-70 & Va. Code § 58.1-602, definition of retail sale).
23. The taxable and exempt use of fuel oil should be examined on an annual basis and the use tax remittance should be adjusted accordingly. Taxpayers should maintain documentation supporting the prorated amounts. (See PD 98-198)
24. Operating supplies which are *actively and continually* consumed in the operation of exempt machinery and equipment are deemed used directly in manufacturing or processing and are not subject to the tax. Thus, cleansing agents used during the production process by a printing company are exempt (these agents are generally referred to as "blanket wash"), cleansing agents used prior to or after a production run are considered general maintenance items and are not exempt. (See PD 98-127)
25. Manufactured signs are classified as tangible personal property for retail sales and use tax purposes. This allows sign manufacturers to purchase materials used to manufacture signs exempt of the tax and requires them to collect tax on the sale price of the finished sign. Sign

manufacturers are also eligible for the manufacturing exemption on their purchase of machinery, equipment and supplies used directly to manufacture signs.

26. Effective July 1, 2009, the fabrication of animal meat, grains, vegetables, and other foodstuffs when the purchaser i) supplies the foodstuffs and they are consumed by the purchaser or his family, ii) is an organization exempt from taxation under § 501 (c)(3) or (c)(4) of the Internal Revenue Code, or iii) donates the foodstuffs to an organization exempt from taxation under § 501 (c)(3) or (c)(4) of the Internal Revenue Code is not subject to sales tax.

D. **Distribution** – Distribution is the transport or conveyance of products after the completion of production and is not part of manufacturing or processing. However, the conveyance of finished products directly from the production line to trucks for shipment is part of exempt manufacturing.

1. Car bracing used to hold cargo in trucks or rail cars is taxable. Where 3/4" steel strapping is typically used for packaging, 1" or larger strapping is used most of the time for car bracing. Lumber and dunnage bags are also used as car bracing.
2. Forklifts used to place the manufactured product in the finished goods warehouse are tax exempt. Forklifts used to take the finished goods out of the warehouse for shipment are taxable. If the same forklift is used both in a taxable and an exempt manner, the preponderance of use rule will apply.
3. Where finished goods and raw material are both stored in the same warehouse, any equipment used will be taxable based on its preponderance of use.
4. Strapping machines and associated supplies used to bundle products so that the bundle can easily be shipped to customers are taxable. The strapping does not constitute materials used to place goods into a package or container for shipment or sale. (See PD 10-85)
5. Air bags used to protect products during transit are not exempt packaging materials. They are more comparable to taxable "transportation devices" which are used to transport and protect products for sale and to restrain movement in a single plane of direction. (See PD 02-126)

E. Examples of items which are generally taxable:

1. Electrical Items

- cable trays
- F96T12CW-flourescent lighting
- F72T12CW- flourescent lighting
- light bulbs
- machinery lights enabling operator to see
- lighting ballast
- contact cleaner
- wire markers

- greenlee electrical tools
- voltmeters

2. Equipment

- hoist, cranes & chains for maintenance of production machinery
- free standing exhaust fans
- pipe cutters
- pipe threading machine
- HVAC for employee comfort
- vacuum systems for housekeeping purposes
- inventory bar code system
- computer equipment to design products
- calibration equipment
- catwalks and ladders
- repair parts and supply storage bins or racks
- chart recorder, chart paper, and pens
- administrative computer hardware and software
- computers for inventory management
- dust covers
- guards
- wearing apparel for employee comfort
- portable dockboards
- raised or false flooring
- fire prevention equipment
- gas cylinder rental or demurrage charges on gas cylinders
- grinder machine and accessories used to sharpen production parts
- pipe identification markers
- general maintenance equipment
- rail car leases
- off site packaging equipment
- off site quality control equipment

3. Supplies

- supply storage tanks
- boiler treatment chemicals
- chemicals and additives that prolong the life of equipment
- fuel for comfort heating
- oil dry
- heat tape to prevent freezing
- acetylene, oxygen, argon-welding gases

Field Audit Procedures – Sales & Use

Tax Topic: Restaurant/Bar Purchase Markup

Revised: September 2016

I. References

- A. Code of Virginia:
 - 58.1-633 (Records)
 - 58.1.625 (Sums held in trust)
- B. Virginia Administrative Code:
 - 23VAC010-210-470 (Dealers Records)
 - 23 VAC 10-210-340 (Collection of tax)
- C. Public Documents:
 - PD 95-224
 - PD 95-162
 - PD 95-61
 - PD 94-232
 - PD 94-213
 - PD 91-276
 - PD 99-28
 - PD 97-303
 - PD 97-298
 - PD 96-287
 - PD 97-149
 - PD 09-23
 - PD 10-234
- D. Exemption Certificate:
 - ST-10
- E. Internal Revenue Service (IRS):
 - Audit Technique Guide (ATG) / Retail Industry / Chapter 4

II. General

Purchase markup procedures are used when restaurants/bars have failed to maintain sufficient records to determine the amount of sales tax collected. The procedures allow the auditor to estimate taxable sales by marking up purchases with ratios derived from known cost and selling prices or industry standards. The portioned purchases of liquor and beer, along with limited sources of supply that occur with a bar make it especially effective. A restaurant's menu will provide good results; particularly, one which lends itself to portion control purchasing. In addition, industry standards provide known benchmarks, which act as a plausibility check for your results, and, may even be used alone to provide a quick and generally accurate result.

III. Procedures

It is already assumed that there are insufficient records maintained by the business. Therefore, the auditor needs to ascertain what records are available that will assist in performing a purchase markup.

- A. **ABC:** When mixed beverages are being sold the business is required to file a Mixed Beverage Annual Review report with the Virginia Alcohol Control Board (ABC). This is done on an annual basis. If the taxpayer does not have his most recent reports, copies can be obtained from ABC by going through the Field Audit Director. The information in the report is provided by the business and purports to be an accurate reflection of the business. The report categorizes sales by mixed beverage, beer & wine, and food for a twelve-month period. It also provides total purchases for each category. This information is useful in several regards.

First, it provides sales information with which to verify what has been reported to the Department of Taxation. Secondly, it provides total purchases, per category, which is useful to have in summary form. And third, it enables the auditor to calculate the Cost of Goods Sold for each category as reported by the business; thereby, providing a quick figure with which to judge the reasonableness of the sales numbers contained in the report. This in itself is a tremendous aid for the auditor. For, given that the purchase figures are correct, the auditor may preemptively conclude that either sales have been accurately reported, albeit with poor records being retained, or that something is amiss and further effort is required. Thus, the auditor has a tool that either confirms the need for a complete purchase markup or allows for the procedure to be aborted before much effort has been expended. After all, the auditor is most concerned with underreported sales and not just the exercise of reconstructing sales. Except, of course, for instances where no sales have been reported at all.

- B. **Purchase Invoices:** After the ABC report has been reviewed, purchase invoices should be reviewed. There is only one legitimate source for liquor purchases. That is the ABC store which serves that particular business area. Beer & wine purchases are almost exclusively made from the few large beer & wine wholesalers that serve the area. The business owner is required by ABC to keep liquor purchase information on the premises. However, if it is felt that the records are incomplete or they are unavailable for review, the auditor may obtain copies of all liquor purchases from the ABC store serving the business. This will be in the form of actual invoices showing the type, quantity, and price of liquor purchased. In like manner, beer & wine wholesalers may be contacted for information concerning their products. Instead of actual invoices, they will provide summary reports showing quantities and sales dollars by product on a monthly basis. These reports usually cover the current and prior year. An ABC agent can facilitate gathering the aforementioned information.
- C. **Review of Alcohol Purchases:** Once the purchase information has been obtained, the total purchase amounts provided on the Mixed Beverage Annual Review report can be verified. Next determine what are the serving sizes and selling prices of the alcohol. This is best accomplished through an interview with the business owner or manager on the initial visit to the location. At that

time, posted prices and bar setup may be observed while discussing the following:

- What serving size for liquor is used? Is it one ounce, ounce and a quarter?
- Is a measured type of system in use or is it free pour?
- At what price is liquor sold at for well, call, and premium brands?
- Is there a happy hour?
- Are just well brands used at happy hour?
- What prices are used at happy hour?
- What size glass is used for draft beer?
- What size are the pitchers?
- What are the regular prices?
- What are the happy hour prices?
- What about bottled beer?
- How much is domestic?
- How much is import and premium?
- Are there any reduced prices with bottled beer?
- Are happy hour records kept?
- Are Z-tapes kept from the cash register?
- Are the Z-tapes consecutively numbered?
- How many cash registers are there?
- How are daily sales recorded?
- Are daily sheets used and maintained?

These questions provide the answers you will need to perform your calculations and also establish the degree of record keeping the business has maintained. In order to facilitate organizing this information the following questionnaire should be used and then maintained as a statement of record as to certain facts pertaining to the taxpayer's business.

General Audit Information Questionnaire

Business Name: _____ Registration # _____

Trade Name: _____ Type of establishment: _____

Street Address: _____ City/Town, State and Zip _____

Type of location of establishment: _____
(Shopping center, Downtown, etc...)

Days/Hours of Operation: Days _____ Hours _____ .
Food percentage sold: _____ Menu provided: yes ___ no ___

Does taxpayer have copies of old menus: yes ___ no ___

Miscellaneous Sales:

Cover Charges – Are cover charges imposed? yes ___ no ___

Records for cover charges kept? yes ___ no ___

How long have cover charges been in effect? _____

Days / Hours cover charges are imposed: Days: _____ Hours: _____

Cover charge imposed: \$ _____ per person, \$ _____ per couple. If different amounts are charged for different times of days, please note: _____

Is anything other than admission included in cover charges? yes ___ no ___

Please note: _____

Other Miscellaneous Sales:

Pool tables / Video Games / souvenirs – Does the applicant or licensee have pool tables or video games or sell souvenirs (such as hats or T-shirts)? yes ___ no ___

If yes, list type(s): _____

Are records for these sales maintained? yes ___ no ___

If records for miscellaneous sales are not kept, approximately how much money is taken in per week from these sales: \$ _____

Alcoholic Beverage Sales

Happy Hours (reduced pricing)

Are there periods when reduced prices are charged? yes ___ no ___

Are Happy Hour records maintained? yes ___ no ___

Days and times of Happy Hours: Days of Week: _____ Hours: _____

How long have these Happy Hour times been in effect? _____

If Happy Hour records are not maintained, obtain the percentage of total alcohol sales derived from Happy Hour. _____%.

How is liquor dispensed: Free pour ___ Gun system ___ Measured pour ___

Summary of Serving Sizes and Prices for Alcoholic Beverages

Item	Regular Serving size (in oz.)	Regular Price	Happy Hour Serving size (in oz.)	Happy Hour Price
Domestic Bottle Beer				
Imported Bottle Beer				
Other Bottled Beer (more than 12 oz.)				
Other Bottled Beer (less than 12 oz.)				
Draft-Glass				
Draft-Pitcher				
Wine sold by bottle.				
Wine sold by glass.				
Mixed Beverages	Amount of liquor used in ounces.	Regular price	Amount of liquor used in ounces.	Happy Hour Price
House Brands				
Call Brands				
Premium Brands				
Exotic Drinks				

Normally restaurants use the cost of each brand to determine the sale price.

Example: 750ml bottles that cost from \$0.00 - \$10.00 are considered house brands, bottles that cost \$10.01 - \$18.00 are considered call brands, etc. Determine the price structure for House, Call, Premium and Exotic brands.

Document the price structure in the chart below:

Mixed Beverage Pricing Structure

House Brand	
Call Brand	
Premium Brand	
Exotic Brand	

Is sales tax included in the price for a drink: yes ___ no ___

Is sales tax separately charged when a drink is bought: yes ___ no ___

Are daily sheets used and maintained: yes ___ no ___

Are Z-tapes kept from the cash register: yes ___ no ___

Are the Z-tapes consecutively numbered: yes ___ no ___

Person providing the information for this questionnaire:

Name: _____ Title: _____ Date: _____

Date of interview: _____ Auditor's Signature: _____

D. **Calculate COGS ratio** The auditor is now prepared to begin constructing worksheets which will put the accumulated information into meaningful form. The goal is to produce a cost of goods sold ratio per category which, in turn, can be applied to the total purchases per category which results in a sales figure based on known facts. This entails arranging the information in such a manner so that the relationship between actual costs and selling prices produces the COGS ratio necessary to project sales based on purchases.

When constructing worksheets, the sale prices used should be net of tax. This allows a true COGS ratio to be developed based on the actual cost and selling prices of the product itself. The sales generated by the worksheets will be taxable sales. Many restaurant/bars include sales tax in the selling price of alcohol beverages, and then back out the tax from their gross alcohol beverage sales and report the result as taxable sales.

Code of Virginia § 58.1-625 requires the dealer to separately state the amount of the tax and add the tax to the sales price or charge. Title 23 VAC 10-210-340(A) further provides that identification of the tax by a separate writing or symbol is not required provided that the amount of the tax is shown as a separate item on the record of transaction. However, Code of Virginia § 58.1-614(D) provides that when a dealer is able to demonstrate to the satisfaction of the Tax Commissioner that it is impractical to collect the tax in accordance with the bracket system it may be authorized to remit an amount based on a percentage of gross receipts which takes into account the inclusion of the sales tax.

If sales tax is included in the selling price, and the taxpayer has not been granted authorization from the Tax Commissioner to do so, then the taxable selling price is the total price received for drinks. If the taxpayer has been granted permission, then the taxable selling price is the selling price less sales tax.

Another factor to consider is that of weighting. What percentage of total sales are attributed to regular prices versus happy hour prices?

The last factor to consider is breakage and spillage - over pouring, foamy beer, breakage, and theft. The following spillage figures, per the ABC, should be utilized in providing an allowance:

- Free-pour liquor and wine -----8%
- Gun-dispensed liquor -----5%
- Beer & Wine by individual container -----5%
- Draft Keg beer ----- No spillage allowed

E. **Food Sales:** ABC regulations require that the food and nonalcoholic beverage sales must account for at least 45% of the gross sales of mixed beverages and food. The menu provides the product along with its selling price. Determine the cost per portion and compare it to the selling price. The resulting COGS percentages for the various entrees are then weighted to establish an overall COGS.

F. Additional Comments:

1. The following COGS ratios provide ballpark numbers to evaluate the Mixed Beverage Annual Review: Liquor - 20%, Beer & Wine - 25%, Food - 45%. If the evaluation of the Mixed Beverage Annual Review shows substantially higher numbers, further investigation is required.
2. The COGS ratio is the relation of cost to sales. The inverse of COGS is the markup factor.
3. A place of business, which sells only beer, is required to have at least \$2000.00 worth of food sales per month by the ABC.
4. Happy Hour time frames cannot extend past 9:00 PM.
5. Businesses are required to maintain separate happy hour records. In practice, this usually takes the form of designated keys on the cash register which segregates happy hour sales on the register tape.

G. Steps to Determine if Purchase Markup is Necessary:

- Review the taxpayer's records in IRMS.
- Determine if sufficient records are available - cash register tapes, balance sheets, profit and loss statements, general ledgers, sales journal, purchase invoices and check register.
- If the records are sufficient, review them to determine if the proper amount of tax has been paid on purchases and collected and remitted on sales.
- To ensure that the proper amount of tax has been submitted, review the cost of goods sold. Divide COGS by gross sales to calculate the cost of goods sold percentage. Compare this percentage to the industry standards.
- If the cost of goods sold percentage is unreasonably higher than the industry standards, calculate taxable sales by using a purchase markup.
- Establish what the selling price is for the different beverages.
- If the selling price seems low, then that might explain why the cost of goods sold percentage is high.
- If the selling price is average for the industry, then that might indicate possible under reporting of sales.

H. Review of Purchase Markup Steps:

Check ABC report if applicable (MBAR) Mixed Beverage Annual Review

- Determine if the totals reported to ABC include sales tax
- Determine if the totals are the same as those on the sales tax returns.
- Make note of the COGS percentage per report.

Obtain Beer and Liquor purchases:

- Contact beer distributors
- Contact ABC

Determine selling prices of beverages

Establish COGS for different categories

- Regular price for liquor
- Happy hour price for liquor
- Regular price for beer
- Happy hour price for beer
- Back out tax from price if required
- Allowance for spillage is factored into all calculations

Weight COGS

Determine how much of each category is sold for:

- Liquor (Well, Call, Premium) and beer (bottles, draft)
- Determine percentage of happy hour pricing versus regular pricing

Divide COGS into total purchases for liquor & beer.

Compare resulting figure with what was reported.

Field Audit Procedures – Sales & Use Tax



Topic: Caterers

Revised: December 2012

I. References

- A. Code of Virginia:
58.1-602
- B. Virginia Administrative Code:
23 VAC 10-210-930
- C. Virginia Tax Bulletins
VTB 92-10
VTB 08-11
- D. Public Documents:
 - PD 09-23 Restaurant Mandatory Gratuity
 - PD 04-223 Taxability of items transferred to customer
 - PD 03-42 Dietary transfers (internal catering) by a hospital are exempt
 - PD 00-48 Food purchased for free distribution at colleges
 - PD 01-225 Labor charges in conjunction with meal catering.
 - PD 97-152 Food Service management company
 - PD 94-39 Catering Supplies & Equipment
 - PD 93-33 Labor Charges of Caterer
 - PD 92-156 Leases & Rentals-Catering Supplies
- E. Exemption Certificate:
ST-10

II. General

- A. Retail sales by caterers are taxable. Code of Virginia § 58.1-602 defines sales price as the total amount for which tangible personal property or services are sold, including any services that are part of the sale. Charges by caterers for cover, labor, minimum, service, set-up, cleaning, and the amount of non discretionary tips which exceeds 20% are subject to sales tax.
- B. Effective 1/1/2005, purchases of items intended to be transferred to the customers of caterers are exempt. Caterers may also rent for “resale” items which are obtained on the behalf of specific customers and for which the charges are passed onto the customers. These charges, in addition to the charges for food and other services, are subject to the sales tax.
- C. Items purchased or leased by caterers for their own use in preparing and serving meals are taxable to the caterer at the time of purchase and are also subject to tax as part of the sales price to the customer.

III. Procedures

A. Purchases:

1. Equipment and supplies purchased and leased by a caterer, for its own use and consumption in preparing and serving meals, are taxable. The tax is applicable at the time of purchase or rental and must be paid to the vendor, provided these items are not resold to customers as part of meals, but instead are consumed by the caterer in providing the meals. Examples of some items subject to the tax are:
 - Kitchen equipment & supplies
 - Cloth linens such as table cloths and napkins
 - Serving trays
 - Serving utensils
 - Serving dishes
 - Plates/China
 - Glassware
 - Silverware
 - Tables - not rented for a specific customer
 - Chairs – not rented for a specific customer
2. Purchases of items furnished with and disposed of after use by a customer are considered part of the meal and may be purchased exempt. These items include:
 - Disposable paper doilies
 - Disposable paper placemats
 - Plastic eating utensils, plates, cups, and lids
 - Plastic or paper bags
 - Disposable serving trays
 - Straws
 - Paper napkins
 - Other similar items
3. Purchases of items intended to be transferred to customers are not taxable to the caterer. Caterers may also rent for resale items which are obtained on the behalf of specific customers and for which the charges are passed onto the customers.

Caterers must document all purchases and rentals of the items for resale purposes. Charges to customers for such items must be

Separately stated on the invoice to the customers. It must be specifically stated that the charges being incurred by the caterers for their customers are the same charges that are being passed on to the caterer's customers and on which tax is collected from the caterer's customers.

Items purchased for transfer to customers include:

- Party accessories, including invitations, favors and decorations
- Flowers and flower arrangements
- Ice sculptures
- Other similar items

Items rented for resale include

- Tables
- Chairs
- Tents Gazebos Arches
- Other similar equipment

The tax is to be collected on the total amount billed to customers, including labor, personnel, set-up, cleaning, serving, equipment & supplies used in the provision of the service, flowers, and any other similar items, even if separately stated on the invoice. All charges for services provided in conjunction with the provision of food services are subject to the sales tax. This also includes the portion of non discretionary tips which exceeds 20%.

Code of Virginia 58.1-609.1(4) provides an exemption from the sales tax for purchases of tangible personal property by the federal, state and local governments of Virginia. 23 VAC 10-210-690 (B) states that charges for catered events are subject to the tax when paid for by state or local governments or public institutions of learning, or employees of such, regardless of whether the purchases are made pursuant to required official purchase orders. 23 VAC10-690(B) also provides that purchases of meals (catering) by the federal government are exempt provided they are made pursuant to an official purchase order (e.g., by direct billing to government or use of government credit card).

The department has consistently held sales by a caterer of meals to local governments and state agencies for consumption by individuals as taxable. However, Public Document 87-245 illustrates a situation in which the sales of food/catered services are exempt because food was served to inmates housed in a jail facility operated by a local government.

When auditing an entity that provides catering to local and state governments, taxation has generally been the rule, with only certain exceptions made. The auditor should check for current rulings or changes in law concerning meals/catering to local and state governments.

Effective July 1997, food purchased for free distribution at the facilities of

colleges or other institutions of learning is exempt from sales tax provided such college or institution of learning is nonprofit. This includes meals and food purchased and prepared by the school. Meals/catering sold in a county run cafeteria to interdepartmental divisions are subject to sales tax since the meals are not consumed by the tax-exempt county.

A court ruling in 2000 determined that dietary transfers (internal catering) by a hospital are exempt from sales and use tax. This does not affect the taxability of meals sold from an outside caterer to the hospital.

The Nonprofit Organization Exemption effective July 1, 2004, does not exempt "taxable services". Therefore, meals purchased by these organizations are subject to the sales tax on and after July 1, 2004.

Field Audit Procedures – Sales & Use Tax

Topic: Controlled Drugs, Durable Medical Equipment, Nonprescription Drugs and Proprietary Medicines

Revised: September 2016

I. References

- A. Code of Virginia:
58.1-609.10 (9) (10) (11) (12) (13) (14)
- B. Virginia Administrative Code:
23 VAC 10-210-940
- C. Tax Bulletin
VTB 98-4 Exemption for Nonprescription Drugs & Proprietary Medicines
- D. Public Documents:
 - PD 11-141 Taxability of breast implants
 - PD 11-75 Distinction between medical drugs and medical devices
 - PD 10-216 Clarification of Supplies to be used in connection with exempt Durable Medical Equipment (Mastectomy Bras)
 - PD 09-6 Bulk purchases of Durable Medical Equipment
 - PD 08-28 Various examples and distinctions of exempt and taxable Durable Medical Equipment
 - PD 07-45 Birth Control Implants (*Device*) do not meet exemption criteria
 - PD 07-14 Exemption of IV medications provided during Home Infusion Therapy
 - PD 06-113 Video & ESO capsules do not meet qualifications for exemption as Durable Medical Equipment
 - PD 05-135 Determining whether item – Metamucil – meets the exemption for nonprescription drugs
 - PD 05-126 Exemption of biological bone replacement devices
 - PD 05-106 Taxability of installed wheelchair lift
 - PD 04-136 Nutritional products sold under DMAS are exempt
 - PD 04-116 Agency relationship between clinic and a Management Company
 - PD 03-30 Taxability of spas & hot tubs
 - PD 03-1 Distinction between medical “drug” and medical “device”
 - PD 00-215 Bulk Purchase of DME later modified for a specific patient
 - PD 94-127 Clarification on implants for cosmetic purposes
 - PD 10-179 Taxability of crowns, caps, alloys, bonding agents, etc.
 - PD 11-7 Taxability of antibacterial gels, soaps, sanitizers

- E. Case Law:
- Northern Virginia Doctors Hospital Corporation v. Department of Taxation - Exemption for drugs sold to a for-profit hospital by a pharmacy upon written order of a physician.
 - Bluefield Sanitarium, Inc v. Department of Taxation - Taxability of drugs purchased by a for-profit hospital's pharmacy for distribution by work order of physician to patients.
 - Bio-Medical Applications of Roanoke Inc. v. Department of Taxation – Purchase of drugs by a clinic to treat patients. Drugs held taxable.
 - Sentara Enterprises Inc v. Virginia Department of Taxation – drugs purchased and sold through clinics to patients of the clinics are taxable similar to Bluefield Sanitarium.
- F. Exemption Certificate – ST 13, Numbered exemption certificate issued by the Department

II. General

- A. Controlled Medicines and Drugs - The sale of controlled medicines or drugs, including oxygen, pursuant to a written prescription of physicians and dentists are exempt from tax. Purchases by physicians (for use in their professional practice), nonprofit hospitals and nonprofit nursing homes that have qualified and obtained a nonprofit letter are also exempt. Due to legislative expansion of the controlled medicines and drugs exemption, for-profit hospitals, nursing homes, clinics and similar corporation were extended the exemption as well. Licensed retail pharmacies may purchase controlled drugs under the resale exemption.

Effective July 1, 1996 an exemption is provided for samples of pharmaceutical products and their packaging distributed free of charge in Virginia to authorized recipients in accordance with the Federal Food, Drug and Cosmetic Act.

Effective July 1, 2006 an exemption is provided for medicines and drugs when sold to a veterinarian used for the treatment of “agricultural production animals” and for medicines and drugs purchased by veterinarians for resale to a farmer for direct use in producing an agricultural product for market.

The term controlled drugs is further restricted to drugs under Schedules I-VI of the Virginia Control Act, Sections 54.1-3446 through 54.1-3456. Generally, controlled drugs and prescription drugs are synonymous in Virginia.

- B. Durable Medical Equipment - The exemption for DME applies to those general categories listed in the regulations or other specific items, which meet the definition that follows. These DME items must be purchased by an individual or on their behalf in order to qualify for the exemption. They also must meet 4 criteria: (1) can withstand repeated use (2) is primarily and customarily used to serve a medical purpose (3) generally is not useful to a person in the absence of illness or injury; and (4) is appropriate for use in the home. Bulk purchases by for profit health care providers and physicians for later distribution to patients do not qualify for the exemption even if later modified for a specific patient.

- C. Prosthetic Devices - The exemption for prosthetic devices applies specifically to those devices purchased by and on behalf of an individual for use by that individual. Bulk purchases for later use or modification are taxable if no other exemption applies (such as that of a nonprofit hospital).
- D. Nonprescription drugs and proprietary medicines – Effective July 1, 1998 the sale of nonprescription drugs and proprietary medicines are exempt from retail sales and use tax. The exemption is applicable regardless of the nature of the purchaser. These may be purchased tax-exempt by individuals, physicians, medical facilities, and all other entities. In addition, effective July 1, 1998, samples of nonprescription drugs and proprietary medicines distributed free of charge by the manufacturer are exempt from the sales and use tax. The exemption includes packaging materials and constituent elements and ingredients. The exemption does not apply to cosmetics.

III. Definitions

- A. Controlled Drugs - Shall mean those drugs itemized under Virginia Code Sections 54.1-3446 through 54.1-3456, but shall include only medicines and drugs and not devices.
- B. Prosthetic Devices - Shall mean devices, which replace a missing part or function of the body and shall include any supplies physically connected to such devices (i.e. ostomy supplies but does not include general supplies such as tape and gauze).
- C. Prescription - Shall mean and include an order for drugs and medical supplies, written, signed or transmitted by word of mouth, telephone, telegraph, or other means of communication to a pharmacist by a duly licensed physician...or other practitioner, authorized by law to prescribe and administer such drugs or medical supplies.
- D. Durable Medical Equipment - is that which:
 1. Can withstand repeated use
 2. Is primarily and customarily used to serve a medical purpose
 3. Generally is not useful to a person in the absence of illness or injury
 4. Is appropriate for use in the home

NOTE: All 4 criteria must be met for an item to be deemed DME.)

- E. Prescription Drug – shall mean any drug required by federal law or regulation to be dispensed only pursuant to a prescription, including finished dosage forms and active ingredients subject to the federal Food, Drug, and Cosmetic Act. (Code of Virginia § 54.1 – 3401)
- F. Nonprescription Drugs – Shall mean any substance or mixture of substances containing medicines or drugs for which no prescription is required and which are generally sold for internal or topical use in the cure, mitigation, treatment, or prevention of diseases in human beings.

- G. Proprietary medicines – Shall mean any nonprescription drug sold to the general public under the brand name or trade name of the manufacturer and which does not contain any controlled substance or marijuana.

IV. Procedures

- A. Medicines and Drugs – The expanded exemption for medicines and controlled drugs has essentially made all purchases of controlled medicines and drugs exempt from sales tax. In addition, it should be noted that the legislative change in 7/1/1998 previously noted, exempts all sales of nonprescription and proprietary medicines as well.

It is important to determine if an item is a controlled drug or a “medical device” which would be taxable if purchased by a taxable entity in bulk. The FDA website or medical reference guides can assist in making this important distinction.

In order to purchase drugs under the “resale” exemption, the seller or physician must hold a special certificate from the Board of Pharmacy, which allows them to “retail” drugs and fill prescriptions accordingly.

(Effective 7/1/2006, physicians, all licensed hospitals, nursing homes and clinics and similar corporations are exempt on purchases of drugs and medicines.)

- B. Durable Medical Equipment - The exemption for durable medical equipment applies only when the DME is purchased by or on behalf of an individual and it meets the definition of DME set forth in the regulations. An extensive list of DME is provided to assist in making this determination. The seller and purchaser of these products must maintain sufficient records to substantiate that the purchase was made for a specific individual's use. Also, legislation passed in 1995, has changed the taxability of purchases by a Medicaid recipient through a Department of Medical Assistance Service (DMAS) agreement. Examples of items that can be purchased tax exempt under the DMAS agreement are bandages, gauze dressings, incontinence products, wound care products, and all supplements provided to patients when considered their sole source of nutrition and a necessity for medical treatment.

DME is medical equipment which can withstand repeated use, is generally and customarily used to serve a medical purpose, is not useful to a person in the absence of illness or injury, and is appropriate for use in the home. If a product does not meet all four criteria, it cannot be exempted as DME. For example, adult diapers are disposable and therefore cannot withstand repeated use. Thus, the exemption does not apply. Supplies, which are specifically designed for use with exempt DME, are also exempt. Examples of these are tubes, pumps, and containers used in conjunction with internal or parental feeding equipment.

Once it is determined that a specific medical item qualifies as DME, it must be verified that it was purchased by or on behalf of an individual for use by such individual. When taxable medical facilities and physicians purchase DME for their patients, they must maintain sufficient documentation to verify that it was bought for a specific patient. In many cases a patient's name appears on the

purchase order and invoice, which is sufficient. If this is not the case, then the seller must obtain a signed statement from the purchaser certifying to the effect that the DME is purchased on behalf of a specific patient through a doctor's prescription or profit hospital's order and is for sole use by such patient. The purchaser must also retain a copy of the prescription or work order as part of the record of the transaction. Bulk purchases for later distribution to patients by any physician or taxable facilities do not qualify for the exemption.

Another issue for medical facilities or DME retailers concerns third party billings to insurance companies and various governmental programs. The tax due is not on the total charge submitted to the third party for reimbursement, but is based on the actual reimbursement amount which is allocated to sales, untaxed charges and tax based on the percentages to the original total charge. As previously mentioned, billings which fall under DMAS are exempt from tax.

- C. Prosthetic Devices - The exemption for prosthetic devices is similar to that for DME in that it only applies when the devices are purchased by or on behalf of an individual using these items. The same documentation requirements are required for these purchases as previously mentioned for DME. The purchases of prosthetic devices are normally on a per patient basis due to the individual nature of the device and use of the device.

The taxability of implants is an area that requires further comment. Implants, such as breast and chin, are considered exempt when purchased by a licensed physician (normally a plastic surgeon) on behalf of a patient, and are used in reconstructive surgery to replace a missing body part. However, implants used for cosmetic purposes do not meet the definition of "prosthetic device" and therefore do not qualify for exemption. A general rule is that normally, insurance companies will not reimburse the physician when the surgery is performed for cosmetic purposes. Also, plastic surgeons will typically order an extra implant on behalf of the patient in case there is a defect, which might be discovered during surgery. If the original implants are exempt, the extra implants are also exempt. Again, bulk purchases are not exempt from tax even if an item later is withdrawn from inventory and modified or fitted for a specific individual.

- D. Nonprescription Drugs and Proprietary Medicines – The exemption for nonprescription drugs and proprietary medicines is item specific. Who or what entity purchases the nonprescription drugs and proprietary medicines is not relevant because these medicines are always exempt. No exemption certificate is necessary.

It is important to determine whether an item purchased is a nonprescription drug or proprietary medicine. The department considers three factors to determine if a product falls within the scope of the exemption: (1) Is the item a nonprescription drug (i.e., is the product a substance or mixture of substances containing medicines or drugs for which no prescription is required); (2) is the product for topical or internal use; and (3) is the product for the cure, mitigation, treatment, or prevention of a disease in human beings.

Cosmetics, toiletry articles, food products and supplements, devices, vitamins and mineral concentrates sold as dietary supplements or adjuncts are taxable. If the taxpayer is not computerized, each individual sale must be examined to ensure tax is not charged on the exempt medicines, and is charged on the taxable items. Retail dealers making sales of nonprescription drugs and proprietary medicines must keep records segregating purchases and sales of exempt items.

If tax is being charged on nonprescription drugs and proprietary medicines the tax collected must be remitted to the state. No refund is to be made to the retailer until it demonstrates that it has refunded this over collection of sales tax to the corresponding customer(s).

Effective July 1, 1998 samples of nonprescription drugs and proprietary medicines distributed free of charge by the manufacturer, including packaging materials and constituent elements and ingredients are exempt from sales and use tax.

V. Use of ST-13 Exemption Certificates

The ST-13 was revised July 2001 and should be used by the specific purchasers and for the specific items and products listed on the exemption certificate form. It should not be used by nonprofit hospitals, nonprofit hospital cooperatives and nonprofit hospital corporations, nonprofit nursing homes, nonprofit adult homes, and other nonprofit medical facilities that are entitled to nonprofit exemptions. These entities are provided an exemption letter and registration number by the department, which should be furnished to their vendors to make tax exempt purchases.

Effective 7/1/2004 – all nonprofit organizations that qualify for the expanded Non Profit exemption must apply and obtain the Non Profit Exemption Letter from TAX. This letter should be provided to their vendors to make tax-exempt purchases.

Field Audit Procedures – Sales & Use Tax

Topic: Mining and Mineral Processing

Revised: December 2012

I. References

- A. Code of Virginia:
 - 58.1-602 and 58.1-609.3 (2)
- B. Virginia Administrative Code:
 - 23 VAC 10-210-960
- C. Public Documents:
 - PD 92-236
 - PD 95-187
 - PD 95-231
 - PD 96-16
- D. Commonwealth of Virginia v. Wellmore Coal Corporation
- E. Exemption Certificates:
 - ST 11, ST-11A

II. General

- A. Code of Virginia Section 609.3.2 exempts machinery or tools or repair parts therefor or replacements thereof, fuel, power, energy, or supplies, used directly in processing, manufacturing, refining, mining or converting products for sale or resale. Machinery, tools and equipment, or repair parts therefor or replacements thereof, shall be exempt if the preponderance of their use is directly in processing, manufacturing, refining, mining or converting products for sale or resale.

- B. Definitions:

"Used directly" refers to all steps of the integrated mining process, but does not include ancillary activities such as general maintenance or administration. It also includes reclamation activities required by state or federal law when performed by the mining company on land which it has previously mined.

The fact that particular property may be considered essential to the conduct of the business of mining or mineral processing because its use is required either by law or by practical necessity does not, of itself, mean that the property is used directly in mining or mineral processing.

Mining and processing are separate and distinct activities. If the ore or mineral excavated is subject to further mineral processing, the exemption may continue under certain circumstances.

“Mining” means both deep and strip mining, quarrying, and other industrial removal of natural resources, minerals, or mineral aggregates from the earth. It does not include the extraction from tailing piles which because of technological advances in processing have become economic mineral deposits.

Direct use in mining begins with the drilling of the shaft in deep mining or the removal of the overburden in strip mining, auger mining or quarrying and ends with the conveyance of the mined product to storage or stockpile at the mine site.

“Mineral processing” is the preparation, refining or concentrating of the ore, resource or mineral subsequent to extraction and prior to distribution for sale and includes cleaning, grading, washing, cracking, crushing, refining and similar processing of the mineral or resource.

Direct use in mineral processing begins with the handling and storage of the raw material at the processing plant site and ends with the conveyance of the processed product to storage at a stockpile at the plant site.

- C. Exploration – Exploration is the search for economic deposits of minerals, ore or coal, and includes the mapping and design of the mine site. All tangible personal property used in exploration is subject to the tax, including drilling equipment used to test the earth and surveying equipment.
- D. Site preparation – Site preparation is the preparation of the mine and includes the removal of the overburden, the clearing of the land at the mine site, construction of access roads, and the construction of tunnels, shafts, and passageways in underground mines.

Removal of the overburden in surface mining operations and at the opening of a deep mine tunnel are part of the mining process, and tangible personal property used in these removal processes is not subject to the tax. Construction of tunnels, shafts, and passageways in underground mines is also an exempt activity.

Other land clearing activities at the mine site or the mineral processing plant site, such as for the construction of a processing plant or office buildings, and the construction and maintenance of access roads, are not a part of mining and property used in such activities is subject to the tax.

- E. Extraction - Extraction is the actual removal of the mineral, ore or natural resource from the earth. It includes severing of the mineral, hauling the mine product from the mine face to a stockpile at the mine site for storage, and reconstruction of tunnels, shafts, and passageways in deep mines. Tangible personal property used directly in extraction is not subject to the tax.

Such items include digging, blasting, and extracting equipment, mine roof support materials, drainage pumps used within the mine, ventilation and dust control equipment used in the mines, transportation devices and equipment used to haul extracted product from the mine face or pit to a stockpile located outside the mine or pit, personnel and supply cars, fuel, supplies, lubricants and repair or replacement parts for exempt equipment, telephones used for dispatching within the mine, and protective apparel and protective materials furnished to production employees.

In Commonwealth v. Wellmore Coal Corporation, it was ruled that methanometers and first aid supplies are also protective materials and are therefor exempt.

Items found to be both essential and used immediately in deep mining, may not meet the direct use test in surface mining. In PD 95-231 the Tax Commissioner upheld the taxing of water trucks used to control dust in surface mining, although dusting control equipment used in deep mining is exempt.

He did, however, rule that because of the broad expanse of land involved in a surface mining operation, two-way radio systems used to coordinate work from different areas of the job site are exempt.

Mining does not include the extraction from tailing piles. No exempt mining activities occur in this process. It does not entail the severance or extraction of minerals from the earth as extraction from the mine has already occurred

- F. Transportation from the mine site – Transportation of the mined product to another location is taxable unless conveyed (a) over a private transportation system owned by the processor and connected to the mine site, or (b) from the mine site to a processing site owned by the same entity.

The Virginia Supreme Court in Wellmore ruled that transporting the coal to the tipple is part of the mining process. Exempt transportation is not limited to the transportation occurring at the plant site. The Court ruled that repair parts and supplies for trucks used to haul coal between mines and the tipple are exempt. Materials used to build and maintain coal haul roads are used directly in the process of mining and are not taxable. The road maintenance materials are also used directly in mining and processing because they facilitate transportation of the coal from the mines to the tipple for processing and are not taxable.

- G. Mineral Processing - Mineral processing generally begins with the handling and storage of the raw material at the processing plant site and ends with the conveyance of the processed product to storage at a stockpile at the plant site. It was ruled in the Wellmore Court Case that weighing of the coal at the tipple, or processing site, is a part of processing because it constitutes handling of raw materials.

Tangible personal property used to clean, grade, wash, crack, crush, and similarly process the mineral or resource at the mine or processing (plant) site is exempt.

Plant construction and administration are not a part of mineral processing and are taxable activities. Construction materials such as concrete, structural steel, and roofing which become permanently incorporated into the processing plant, and machinery and tools used in the construction of the plant are subject to the tax.

Steel or similar supports which are component parts of exempt processing equipment or machinery and which do not become permanently affixed to realty are not subject to tax. Concrete foundations onto which such supports are bolted, floors on which machinery rests, and structures housing equipment and machinery are not used directly in processing and are subject to the tax. Inspection and testing at the mine or plant site to determine the quality of the product and to determine if the product meets industry standard is deemed to be a part of mining and mineral processing and is an exempt activity.

Any testing not related to product quality control is not part of mining or mineral processing and is a taxable activity. Examples of taxable research are efficiency surveys, management studies, consumer surveys, economic surveys, advertising, or promotions.

- H. Refuse - Transportation of a waste product from the processing plant to a waste dump at the plant site is a part of production line quality control and is included in mineral processing. Systems used to transport the waste product from the production line at the processing plant to the dump are not subject to tax provided the dump is located at the processing plant site and the transportation to the dump is continuous and without interruption. The dump must be connected to the processing plant via a private transportation system entirely owned or leased by the processor. If public roadways or transportation systems are used between the processing plant and the dump, no exemption is available for property used to convey the waste between the two sites.

In PD 92-236, the Tax Commissioner ruled that materials used in the construction of refuse hauling roads are taxable. Only roads used in the transportation of coal for further processing may possibly be exempt.

- I. Repair and Maintenance - Repair and maintenance is the repair of machinery, tools and equipment, routine maintenance in order to insure that machinery and equipment are in good working order, and the repair and maintenance of offices, outbuildings, and other real or tangible personal property connected with the operation of the mine.

Repair and maintenance is not mining. Therefore, repair and maintenance facilities, including tools, supplies, machinery and equipment used in performing repair and maintenance work are subject to the tax.

Replacement and repair parts for exempt machinery and equipment, as well as operating supplies which are actively and continually consumed in the operation of exempt machinery and equipment, are deemed used directly in mining and mineral processing and are not subject to the tax.

Machinery and tools used by the person engaged in mining or mineral processing to fabricate exempt machinery or equipment are exempt from the tax if the preponderance of their use is in an exempt manner.

- J. Distribution - Distribution is the transport or conveyance after the completion of mining or processing of the product and is not a part of mining or mineral processing. It includes the storage of the product subsequent to its extraction (other than for further processing at the mine site) or processing, and the actual transport of the product for sale. All tangible personal property used to convey, transport, handle or store the product is taxable.

- K. Reclamation - Reclamation is the restoration or conversion of mined land to a stable condition and the ongoing restoration or conversion of land currently being mined prior to total site reclamation. The process includes recontouring, reseeding, and reforesting the land. Reclamation activities required by state or federal law are a part of the mining process when performed by a mining company on land which it has previously mined. Reclamation activities which are not required by federal or state law are not a part of mining and tangible personal property used in such activities is subject to the tax.

The Tax Commissioner ruled in PD 95-187 that, although required by law, the reclamation of access roads, refuse areas and areas other than the land that was actually mined, is not considered part of the mining process.

- L. Pollution Control - Code of Virginia § 58.1- 609.3.9 (ii) provides an exemption ending July 1, 2006 for certified pollution control equipment and facilities which have been certified by the Department of Mines, Minerals, and Energy as

being used primarily for the purpose of preventing or abating air or water pollution for coal, oil and gas production. This is applicable to both real and tangible personal property. Only property or facilities certified on or before July 1, 2006 qualify for exemption.

Tangible personal property used in or at settling ponds, refuse areas and other spoil areas are typically used to prevent or abate pollution. Once certified, such property is exempt.

- M. Contracted Activities - The mining and mineral processing exemption extends to persons engaged in any phase of mining or mineral processing, provided such activities qualify for exemption. This requires that activities be performed at the mine or mineral processing plant site.

In PD 96-16, the Tax Commissioner ruled that the raw coal hauling activity performed by a trucking company under contract to haul coal from the mine to the tipples for a coal company who owns both the mine and the processing facility would qualify for exemption. As such, truck parts used on trucks in such hauling activity would qualify for the exemption. If the trucks are not used or licensed for use on the public highways, then such trucks could be purchased exempt of the retail sales and use tax. This ruling, however, has no application to trucks used or licensed for use upon public highways. The purchase of a highway truck is subject to the Virginia motor vehicle sales and use tax.

- N. Preponderance of Use - When a single item of tangible personal property is used in both exempt and taxable activities, the sales and use tax shall apply in full when the preponderance of the item's use (fifty percent or more) is in taxable activities. Likewise, the item will be totally exempt from the tax if the preponderance of its use is in exempt activities.

III. Procedures

When auditing coal mining companies, the auditor will primarily be reviewing expensed purchases and fixed assets. Typically the only sales requiring review are disposals of fixed assets.

Begin with a discussion of the taxpayer's operation. Some mining companies perform all the functions of mining and mineral processing. Others perform only the mining function. Others will contract out such functions as extraction, coal hauling, and reclamation. The taxpayer may have locations both within and without Virginia. Request a listing of all the taxpayer's related companies. The listing should include a brief description of each company's business and the location of the business operation. It is not unusual for a coal company to have several related mining companies, as well as non-mining entities. Utilize the taxpayer's income tax returns to verify that the listing is complete.

Determine the type of mines, such as deep or strip, that the taxpayer operates and the type of facilities owned by the taxpayer. Schedule a tour of the facilities prior to reviewing invoices so that areas of potential liability such as clean coal stock piles, loadouts, refuse haul roads, repair shops, bathhouses and administrative buildings can be identified. Especially note which pieces of heavy equipment are being used in taxable areas.

Review the disposals of fixed assets for possible taxable sales.

Determine how each item listed on the depreciation schedule or other fixed asset listing is being used. Determine the preponderance of use for items used in both taxable and

exempt activities. The burden of proof is on the taxpayer to document that an item's use is more than 50% exempt. Assets used indirectly in mining that are transferred from a related company may be taxable at their current value if no tax was paid on the original purchase and the assets continue to be used indirectly in mining. The use of the asset may have changed, making it taxable, or it may have been transferred from a non-Virginia location where the item enjoyed a sales tax exemption.

Purchases of equipment used to abate or control air or water pollution must be certified in order to be exempt. The taxpayer should provide documentation that the equipment has been certified, or obtain certification during the audit. If not, the equipment should be taxed.

Some expensed items purchased by the taxpayer may be exempt or taxable depending upon their use. For example, stone for refuse haul roads is taxable, but stone purchased for use on coal haul roads is exempt. When reviewing purchase invoices, a chart of accounts or general ledger with a brief account description should be used to help determine the taxability of expensed purchases. Information written on the purchase order or on the invoice itself may assist the auditor in determining how an item is used. If the accounts or descriptions are too general or if the items are purchased in bulk, the items should be taxed at an agreed percentage. Fuel and other supplies identified as being purchased for a particular piece of equipment should be prorated even though the equipment, itself, may be totally taxable or exempt because of the preponderance of its use.

Field Audit Procedures – Sales & Use Tax



Topic: Oil and Gas Production

Revised: December 2012

I. References

- A. Code of Virginia:
 - 58.1- 609.3.9 (ii)
 - 58.1-609.3.12
- B. Virginia Administrative Code:
 - 23 VAC 10-210-960
- C. Public Documents:
 - PD 89-55
 - PD 94-123
 - PD 94-250
 - PD 98-17
 - PD 04-34
 - PD 07-71
 - PD 12-73
- D. Exemption Certificates:
 - ST-11, ST-11A

II. General

- A. Code of Virginia § 58.1-609.3.12 exempts raw materials, fuel, power, energy, supplies, machinery or tools or repair parts therefor or replacements thereof, used directly in the drilling, extraction, or processing of natural gas or oil and the reclamation of the well area.
- B. **Definitions:**
 - "Used directly," means those activities which are an integral part of the production of a product, including all steps of an integrated manufacturing or mining process, but not including ancillary activities such as general maintenance or administration. It also includes reclamation activities required by state or federal law when performed by the mining company on land which it has previously mined. The fact that a particular item is required either by law or by practical necessity does not, of itself, mean that the property is used directly.
 - Mining" includes gas and oil drilling.
 - "Natural gas" means gas, natural gas and coalbed methane gas as defined in Code of Virginia § 45.1-361.1.

“Drilling”, “extraction ” and “processing” includes production, inspection, testing, dewatering, dehydration, or distillation of raw natural gas into a usable condition consistent with commercial practices, and the gathering and transportation of raw natural gas to a facility wherein the gas is converted into such a usable condition.

C. Exploration:

Exploration is the search for economic deposits of natural gas or oil, and includes the mapping and design of the drilling site. All tangible personal property used in exploration is subject to the tax, including drilling equipment used to test the earth and surveying equipment.

The commencement of drilling in an area known to contain significant deposits of gas or oil, with the intent of extracting merchantable quantities of oil or gas is an exempt activity, whether or not merchantable quantities are actually produced. However, test well and similar drilling which is intended to discover if deposits of gas or oil exist at a potential site are taxable exploration activities. (See PD 89-55)

D. Site Preparation:

Site preparation is the preparation of the well location to facilitate the extraction of the resource and includes the removal of the overburden, the clearing of the land at the well location, and construction of access roads.

Grading the area of the well location to prepare the well location for drilling is part of the drilling process, and tangible personal property used directly in this process is not subject to the tax. Other land clearing activities at the well site or at the processing plant site, such as for the construction of the plant or office buildings, and the construction and maintenance of access roads, are not a part of mining and property used in such activities is subject to the tax.

E. Extraction:

Extraction is the actual removal of the natural gas or oil from the earth. It includes the drilling, completion and equipping of an oil or gas well. Tangible personal property used directly in extraction is not subject to the tax.

Drilling includes drilling the wellbore, inserting casing, and pumping cement into the well. Completion may include perforating the casing, fracturing productive formations, acidizing the formations, and plugging the casing. (See PD 94-250 and PD 98-17) Equipping a well includes the wellhead equipment mounted at the opening of the well, pumps, compressors, or other equipment used to increase production of the well, separators, and meters used to test and evaluate the well. Equipment, supplies, fuel, lubricants, and repair or replacement parts for such equipment used directly in extraction activities, as well as protective apparel and materials furnished to production employees, are exempt.

Untitled trucks and other equipment used to transport exempt equipment and materials to the well location are taxable. Taxable trucks include vehicles on which exempt equipment is mounted. Purchases of replacement parts and supplies including tires, oil, and air filters for such trucks and equipment are subject to the tax.

Pit and pond liners used to collect drill cuttings and drilling fluids are not used directly in the drilling process and are subject to the tax. Tanks used to store fracking fluids, waste water produced during the drilling process, and water separated from the extracted gas are also subject to the tax. However, some of the liners and tanks may be exempt provided they are certified as pollution control equipment. (See PD 94-123)

F. Transportation from the well site:

Natural Gas – The gathering and transportation of raw natural gas to a facility wherein the gas is converted to a usable condition is exempt.

The Tax Commissioner ruled in PD 94-123 that pipelines used to transport gas from the well site to a processing facility were analogous to coal haul roads. Thus materials used to build and maintain such pipelines are exempt.

However, this ruling was issued prior to the enactment of the oil and natural production exemption on July 1, 1994. Code of Virginia § 58.1-609.3 12 provides a broader exemption for transportation of natural gas than intended by the mining regulation of Title 23 VAC 10-210-960 for the transportation of ore/coal.

Oil - Because the transportation of oil is not exempted by statute, the tax application of oil transportation would follow the same rules as set out for mining in Title 23 VAC 10-210-960. For instance, when the oil well site and oil processing plant or refinery are owned and operated by the same person, transportation from the oil well site to the oil processing site or refinery is an exempt activity.

G. Natural Gas or oil processing:

Tangible personal property used to remove oil and condensate, water, and other liquids and gases, and similarly process the gas or oil is exempt

Plant construction and administration are not a part of mineral processing and are taxable activities. Construction materials such as concrete, structural steel, and roofing which become permanently incorporated into the processing plant, and machinery and tools used in the construction of the plant are subject to the tax.

Steel or similar supports which are component parts of exempt processing equipment or machinery and which do not become permanently affixed to realty are not subject to tax. Concrete foundations onto which such supports are bolted, floors on which machinery rests, and structures housing equipment and machinery are not used directly in processing and are subject to the tax.

Inspection and testing to determine the quality of the product and to determine if the product meets industry standard are deemed to be a part of drilling, extraction, refining and processing and are exempt activities.

H. Repairs and Maintenance:

Repair and maintenance facilities, including tools, supplies, machinery and equipment used in performing repair and maintenance work of both taxable and exempt equipment, are subject to the tax.

Replacement and repair parts for exempt machinery and equipment, as well as operating supplies which are actively and continually consumed in the

operation of exempt machinery and equipment, are deemed used directly and are not subject to the tax.

Machinery and tools used by the person engaged in oil or gas processing to fabricate exempt machinery or equipment are exempt from the tax if the preponderance of their use is in an exempt manner.

I. Distribution:

Distribution is the transport or conveyance after the completion of drilling or processing of the product and is not a part of processing. It includes the storage of the product subsequent to its extraction (other than for further processing) or processing, and the actual transport of the product for sale. All tangible personal property used to convey, transport, handle or store the product is taxable.

J. Reclamation:

Reclamation is the restoration or conversion of the well area to a stable condition and the ongoing restoration or conversion of land currently being drilled prior to total site reclamation. The process includes recontouring, reseeding, and reforesting the land. Well area reclamation activities required by state or federal law are exempt. Access roads leading to the well area are not part of the well area.(See PD 94-123) Tangible personal property used in reclamation of access roads, pipeline right-of-ways and all other areas, and in other reclamation activities which are not required by federal or state law, are subject to the tax.

K. Pollution Control:

Code of Virginia § 58.1- 609.3.9 (ii) provides an exemption ending July 1, 2006 for certified pollution control equipment and facilities which have been certified by the Department of Mines, Minerals, and Energy as being used primarily for the purpose of preventing or abating air or water pollution for coal, oil and gas production. This is applicable to both real and tangible personal property. Only property or facilities certified on or before July 1, 2006 qualify for exemption.

L. Contracted Activities:

The oil or gas processing exemption extends to persons engaged in any phase of oil or gas processing, provided such activities qualify for exemption.

M. Preponderance of use:

Machinery, tools and equipment, or repair parts therefor or replacements thereof, shall be exempt if the preponderance (more than 50%) of their use is directly in the drilling, extraction, refining, or processing of natural gas or oil for sale or resale, or in well area reclamation activities required by state or federal law.

III. Procedures

When auditing oil and gas companies, and businesses that service the oil and gas industry, the auditor will primarily be reviewing expensed purchases and fixed assets. Typically the only sales requiring review are disposals of fixed assets.

Begin with a discussion of the taxpayer's operation. Determine the properties and facilities owned by the taxpayer. Most oil and gas companies contract functions relating to site preparation, well drilling and completion, pipeline installation, reclamation, and well maintenance. Often time the oil and gas companies purchase the materials used in the different functions, and the contractors/service providers own the equipment necessary to perform the functions. The auditor should determine what activities are contracted, who owns the equipment, and who purchases the materials.

Request a listing of all of the taxpayer's related companies. The listing should include a brief description of each company's business and the location of the business operation. It is not unusual for an oil and gas company to have several related companies, including non-mining entities. Utilize the taxpayer's income tax returns to verify that the listing is complete.

The major assets owned by oil and gas companies are the wells. The auditor should sample these as the capitalized purchases for a single well are voluminous, and the purchases for wells are repetitive in nature. The auditor may wish to sample a block period of capitalized well purchases, or capitalized purchases for a single well. If the taxpayer owns both conventional wells and coalbed methane gas wells, the auditor should sample one of each type. All other assets should be reviewed in detail.

Determine how each item listed on the depreciation schedule or other fixed asset listing is being used. Determine the preponderance of use for items used in both taxable and exempt activities. The burden of proof is on the taxpayer to document that an item is used 50% or more of the time in exempt activities.

Purchases of equipment used to abate or control air or water pollution must be certified in order to be exempt. The taxpayer should provide documentation that the equipment has been certified, or obtain certification during the audit. If not, the equipment should be taxed.

One area to be aware of is the purchase of stone, culvert pipe, etc., used for site preparation and reclamation of access roads. Most taxpayers incorrectly consider the access road as part of the exempt well area, and the purchases (of these items) are lumped together. Thus, a percentage of the purchase must be taxed. The percentage could vary; so it is recommended that an analysis of the contract or other pertinent documentation be performed to determine the cost of these items used in the exempt well area versus non-exempt areas outside of the well area. For related information, see P.D. 02-49.



Field Audit Procedures – Sales & Use Tax

Auto Dealers and Auto Repair Shops

Objective: Discuss the application of sales and use tax (retail sales tax) as it applies to auto dealers and auto repair shops.

Revised: April 2023

I. References

A. Code of Virginia

- 58.1-602 & 58.1-2401 (Definition of "motor vehicle")
- 58.1-609.1(2) (Motor vehicle exemption)
- 58.1-609.3(10) (Limited exemption for taxicab operators)
- 58.1-609.5(2) (Repair labor exemption)
- 58.1-609.5(8) (Diagnostic labor exemption)
- 58.1-609.5(9) (Parts & labor maintenance contracts)
- 58.1-609.10(12) (Special equipment-handicapped)
- 58.1-604.1 (Motor vehicles, machinery, tools and equipment brought into Virginia for use in performing contracts)
- 58.1-640-58.1-644 (Tire Recycling Fee).

B. Virginia Administrative Code

- 23 VAC 10-210-10 (Adjustments, replacements and warranties)
- 23 VAC 10-210-910 (Maintenance contracts and warranty plans)
- 23 VAC 10-210-990 (Motor vehicle sales, leases, and rentals, repair and replacement parts and maintenance materials; taxicabs)
- 23 VAC 10-210-1020 (Motor vehicle refinishers, painters and car washers)
- 23 VAC 10-210-3050 (Repair businesses)
- 23 VAC 10-210-4040 (Services)

C. Virginia Tax Bulletins

- VTB 17-7 (Automobile Repair Shop Supplies)
- VTB 95-8 (Parts and labor maintenance contracts)
- VTB 94-10 (Application of the sales tax to disposal fees on waste tires and other environmentally hazardous materials)

D. Public Documents

- Shop Supplies
- PD 17-138, PD 96-389

- Environmental, Waste, and Disposal Fees
- PD 97-73, PD 96-389, PD 04-166, PD 06-115

Diagnostic Fees – Prior to 07/01/2023
PD 13-223, PD 17-188, PD 16-159, PD 20-122

Road Service & Mileage Fees – Prior to 07/01/2023
PD 22-101, PD 17-188, PD 08-67, PD 11-74

Miscellaneous

PD 96-34 Farm Vehicle, PD 94-301 Farm Vehicle, PD 08-54 MV Refinisher, PD 05-101 MV Refinisher, PD 94-6 Leased Vehicles, PD 91-14 MV Lease, PD 13-109 MV Rental Tax, PD 87-264 MV Warranty, PD 87-262 MV Warranty, PD 88-210 MV Warranty, PD 95-54 Church Vehicle, PD 89-115 Taxicabs, PD 86-118 Demonstrator Vehicle, PD 88-20 Parts Update, PD 96-157 Mobile Office, PD 89-294 Wheelchair Lift, PD 96-318 MV Sales Price, PD 95-327 Used Car Guide, PD 95-14 MV Upfittings, PD 88-299 Online Database, PD 96-331 Tracking Device, PD 20-206 Peer to Peer

E. Exemption Certificate – ST10

Note: a used car dealer who is not registered for the retail sales and use tax and makes no retail sales of tangible personal property may use his DMV number on the ST-10 to purchase parts exempt of the tax to recondition cars for sale.

II. General

An automotive dealership is a collection of specialized automotive shops operating as one business. The dealer is involved with some or all of the following: (1) the sale, lease, and rental of new or used cars and trucks, (2) the sale of auto parts, (3) auto repairs and service, and (4) auto body shop repairs.

III. Procedures for Sale, Lease or Rental of New and Used Vehicles

A. Sale of Motor Vehicles; Motor Vehicle Defined Code of Virginia § 58.1-609.1(2) provides an exemption for motor vehicles, trailers, semitrailers, mobile homes and travel trailers. § 58.1-602 defines "motor vehicle" by referring to the DMV definition found in § 58.1-2401, subject to the Virginia Motor Vehicle Sales and Use Tax, and upon the sale of which all applicable motor vehicle sales and use taxes have been paid. 23 VAC 10-210-990(B) provides a partial listing of vehicles subject to the DMV tax which includes "vehicles that are self-propelled or designed for self-propulsion and every vehicle drawn by or designed to be drawn by a motor vehicle, including mobile homes and every device in, upon or by

which, any person or property is, or can be, transported or drawn upon a highway, but excepting devices moved by human or animal power, ... and vehicles, other than mobile homes used in Virginia but not required to be licensed by the state." Effective October 1, 2018, all-terrain vehicles, mopeds, and off-road motorcycles are included in the definition of a "motor vehicle" and are subject to the Motor Vehicle Sales and Use Tax administered by the DMV (see 2018 Legislative Summary). For these particular items, the Motor Vehicle Sales and Use Tax is imposed at the same rate as the Retail Sales and Use Tax, including the special tax rates for the Northern Virginia, Hampton Roads, Central, and Historic Triangle regions. All-terrain vehicles, mopeds, and off-road motorcycles that are titled for the first time in the Commonwealth are exempt from the Motor Vehicle Sale and Use Tax if the applicant can show that either they have owned the vehicle for more than twelve months, or can provide evidence that the Retail Sales and Use Tax has already been paid.

- B. Daily Rentals vs. Long-term Leases. The application of the DMV tax determines whether a vehicle is a daily rental vehicle (i.e., an airport "rent-a-car") or a long-term lease vehicle (i.e., a 1 to 4 year lease). The rental vehicle plus all repair parts and routine service supplies which actually become part of the vehicle (i.e., a replacement headlight, oil, antifreeze) may be purchased by the dealer under the resale exemption.

Effective July 1, 2012, the administration of the Motor Vehicle Rental Taxes and Fees (Rental Tax) transferred to the Department of Taxation (see PD 13-109). The tax is imposed on the rental, for a period of less than 12 months, of motor vehicles with a gross vehicle weight rating or gross combined weight rating of 26,000 pounds or less at a rate of four percent of the gross proceeds. An additional tax is imposed on the rental of every motor vehicle regardless of the weight, except for motorcycles and manufactured homes, at a rate of four percent of the gross proceeds. A two percent fee is also levied on the gross proceeds from the rental of motor vehicles, except for motorcycles and manufactured homes. Most passenger vehicles that are rented are subject to the Rental Tax at a combined rate of ten percent of the gross proceeds.

A long-term lease vehicle, however, is titled to the leasing company (the lessor) which pays the DMV tax on the purchase price of the vehicle including any accessories added to the vehicle prior to titling. The monthly lease payments are not subject to either the DMV tax or the retail sales tax. The lessor is considered the user and consumer of any accessories (i.e., cruise control, air conditioning or upgraded sound system) added to a long-term lease vehicle after the DMV tax is computed and for any repair parts and routine service supplies purchased for the vehicle during the life of the lease. The auditor should check fleet car, truck and trailer leases which can include a provision for some or all of the maintenance. This provision is rarely found in an individual retail lease.

Effective 10/1/2020, Peer-to-Peer vehicle sharing is subject to the Peer-to-Peer Vehicle Sharing Tax (PTP Tax) component of the Motor Vehicle Rental Tax (See

PD 20-206). Individuals placing their personal motor vehicles on peer-to-peer Internet auto rental apps do not enjoy the exemption provided under 23 VAC 10-210-990. The Internet auto rental app is responsible for the collection of the motor vehicle rental tax (not the individual), the personal motor vehicle is not titled with DMV as a rental vehicle, and the vehicle is available to the owner for personal use.

- C. Preparation of New or Used Motor Vehicles for Sale, Lease or Rental
23 VAC 10-210-990 provides that a dealer, lessor or renter of motor vehicles may purchase exempt of the tax repair and replacement parts and accessories and oil and grease installed on a motor vehicle before or at the time of sale, lease or rental which are included in the sales price for measuring the [DMV] tax or the retail sales and use. Exempt purchases include accessories and supplies such as anti-theft devices, floor mats, motor oil, antifreeze, windshield washer fluid, etc. (Note that a used car dealer who is not registered for sales tax may use its DMV number on an ST-10.)

The dealer is the consumer of all maintenance materials and equipment used to prepare the vehicle for sale, lease or rental. Retail sales tax should be paid at the time of purchase or when any such item is withdrawn from an exempt resale inventory. Examples of taxable materials are soaps, cleaners, rags, brushes, sponges, buffers, vacuum cleaners, etc. Preparation materials which adhere to or are absorbed by the vehicle (i.e., waxes, leather and fabric treatments, etc.) may be purchased by the dealer exclusive of retail sales tax because they are incorporated into the vehicle. Promotional items such as key tags, personalized paper floor mats, logo umbrellas, etc. are considered taxable to the dealer under the advertising regulation (even though they are "sold" with the car).

- D. Demonstrators and Executive Vehicles Accessories, repair parts and routine service supplies are taxable if purchased by a dealer for a vehicle used in a taxable manner. This includes demonstrators which are ordinarily driven by employees of a dealer (see PD 86-118), executive vehicles driven by dealership owners, or management and loaner vehicles. Even though they may remain in the new or used vehicle inventory and are always for sale, the dealer is considered to be operating the vehicle for his own use and is denied the resale exemption. Once the vehicle is no longer being used in a taxable manner and is being prepared for sale, the resale exemption becomes available to the dealer.
- E. Sales of Extended Warranty Plans and Vehicle Service Contracts
Code of Virginia § 58.1-609.5(1) provides an exemption from the sale and use tax for insurance transactions which involve sales as inconsequential elements for which no separate charges are made. In addition, 23 VAC 10-210-910 provides that extended warranty plans issued by an insurance company regulated by the Bureau of Insurance of the State Corporation Commission are insurance transactions and are not subject to the tax.

Plans which identify the seller, dealer or manufacturer as the guarantor, (the party generally identified as "We" in the contract), against certain specified motor vehicle breakdowns, are not considered contracts of insurance subject to

licensure or regulation by the Bureau of Insurance. This is true although such contracts might be issued through an insurance agent or underwritten by an insurance company which is licensed or regulated by the Bureau. However, plans which do identify some party outside the manufacturing/sales chain as the "We" guaranteeing against the covered breakdowns are generally considered by the Bureau of Insurance to be contracts of insurance subject to regulation and licensure by the Bureau.

All extended warranty plans and/or vehicle service contracts issued by Virginia automobile dealers are subject to sales tax at the time of sale to customers. They are not subject to the DMV tax. Tax is computed on one-half (50%) of the total charge.

F. When DMV is Erroneously Charged Review "deal" files (dealer term referring to the paperwork connected with an individual sale and trade, if any) to see if the dealer is including sales subject to the Retail Sales and Use Tax in the DMV tax calculation. The dealer owes sales tax on such sales, but should not be assessed penalty, provided the DMV tax was paid. The dealer should be advised to contact the DMV to inquire about a refund.

G. Motor Vehicle Sales are Subject to Sales Tax when No DMV Tax is Paid
The DMV tax is generally paid by the purchaser when a new title is issued. However, sales of motor vehicles are subject to the retail sales tax when the DMV tax would normally apply but was not paid. For example, old cars are often sold to individuals for parts or restoration. If the purchaser does not title the car, he is liable for the Consumer Use tax. However, most sales between individuals (or when the seller is not registered to collect the retail sales tax) are exempt occasional sales. If a dealer gives the purchaser a properly executed title, he is not required to collect the retail sales tax. Conversely, if a dealer does not provide the purchaser with a properly executed title, he is required to collect the retail sales tax unless the sale would otherwise be exempt. The sale of a vehicle that is subject to the DMV regulations, but exempted from the DMV tax, is not subject to the retail sales tax. For example, DMV exempts the sale of a motor vehicle designed for the transportation of ten or more passengers when purchased by and for the use of a nonprofit church. The sale of such a motor vehicle creates no retail sales tax liability.

IV. Procedures for the Sale of Auto Parts

A. Sale of Auto Parts The retail sale of parts is taxable. At a dealership, there is almost always a separate accounting for parts sales. Sales are invoiced to customers on parts tickets or counter tickets which usually have their own numbering sequence and are filed by ticket number or by date.

B. Exemption Certificates Many customers can provide valid exemption certificates including federal, state and local governments, farmers, auto parts stores, garages, service stations and other dealers. Remember that a used car

dealer can use his DMV number on the ST-10 to purchase parts exempt of the tax to recondition cars for sale.

- C. Purchases of Taxable and Exempt Inventories Dealers may purchase parts for resale inventories exempt of the tax. Dealers may also purchase shop supplies consumed in repair services exempt of the tax (whether transferrable or non-transferrable) as long as the dealer separately states shop supply charges on their customer invoices. Purchases of administrative items, and supplies not consumed in repair services, are generally subject to the Retail Sales and Use Tax.

V. Procedures for Auto Repair Shops

23 VAC 10-210-3050 provides that repair businesses must collect the tax on the parts, materials and supplies sold. Repair labor is exempt only when separately stated. Repair and replacement parts may be purchased exempt of the tax for sale or resale, but the tax must be paid on equipment and tools. Tax must also be paid on any items of tangible personal property that are consumed by non-repairman employees or customers of the repair shop. Shop supplies may be purchased exempt of the tax as long as the repair business separately states shop supply charges on their customer invoices.

- A. Sales A motor vehicle dealer's auto repair shop sales are almost always accounted for separately. Auto repair shop sales are usually divided into three areas: (1) the repair of vehicles for which the customer is responsible for payment, (2) warranty repairs for which the vehicle manufacturer, dealer or issuer of an extended warranty plan or vehicle service contract is responsible for payment and (3) internal repairs which include any work on the dealer's own vehicles or motor vehicles in the new and/or used inventories. Auto repair shops usually invoice their customers on repair orders (ROs). One repair order could conceivably include all three areas. In this instance, many dealers print separate repair orders for each area using the same repair order number. The customer usually only sees the price details for those items for which he pays. Repair orders usually have their own numbering sequence and are filed by number.
- B. Exemption Certificates Many customers can provide valid exemption certificates for vehicle repairs. The resale exemption is appropriate when another dealer or repair business has sublet work done on their customer's vehicle.
- C. Repair and Fabrication Labor Separately stated repair labor is exempt. If only one price is quoted which includes both parts and repair labor, then the retail sales tax will apply to the total charge. Verify that taxable fabrication labor is not being treated as exempt repair labor. This occurs most frequently in specialty repair shops where, for instance, instead of repairing an existing drive shaft, a new one is fabricated.

D. Coupon and Discount Programs Most motor vehicle dealers offer coupon or other discount programs. Often, the discount is credited to separately stated labor so there is no retail sales tax impact. If the offer is for a free service such as an oil change, then the dealer becomes responsible for consumer use tax on any supplies (oil, and filter, shop supplies) withdrawn from an exempt resale inventory.

E. Sublet Repairs Sublet repairs occur when the dealer sends a part from a customer's vehicle or the vehicle itself to be worked on at another repair shop. Some dealers also show towing charges in this category. If the sublet repair is strictly labor (i.e., grinding valves by a machine shop) and is described as such on the repair order, then no retail sales tax applies to the sublet repair. If the sublet repair is for both parts and labor and only one price is quoted on the repair order, then retail sales tax must be charged on the entire sublet repair. A good method of accounting for sublet repairs is for the dealer to itemize the sublet parts (which do not have to be identified as sublet) in the parts sales area of the repair order. The customer is then taxed on the correct (and often marked-up) price. In this method, only exempt sublet repair labor or services are shown in the sublet area of the repair order. If the dealer erroneously pays tax to the sublet shop, he is not relieved from charging his customer the retail sales tax.

F. Manufacturer's Warranty and Dealer Guarantees There is no sales or consumer use tax liability on parts or accessories withdrawn from an exempt resale inventory for replacement or exchange under a manufacturer's warranty or dealer guarantee as long as there is no charge to the customer. 23 VAC 10-210-10 states that the "tax must be computed on the actual additional amount, if any, paid to the dealer for the new article."

The auditor should establish what, if any, guarantees are offered by the dealer. Even if no formal guarantee exists, there is usually an implied guarantee between 30 and 90 days. If the dealer does not have a formal guarantee exceeding this period, any replacements withdrawn from an exempt resale inventory and given to the customer are subject to consumer use tax, as the dealer was under no obligation to make the free replacement and did so at his own discretion.

G. Extended Warranty Plan Transactions and Customer Deductibles If retail sales tax was charged on the sale of an extended warranty plan or vehicle service contract (plan), and the plan requires that the customer pay a deductible amount for a covered repair, such deductible amount is not subject to the retail sales tax. Likewise, if the dealer bills the issuer of such a taxed plan for reimbursement, there is no retail sales tax due. Plan transactions become extremely complicated because they seldom cover all of the repairs. Parts not covered by the plan are taxable to the vehicle owner.

H. Internal Repair Orders Most internal repair orders are for the preparation of vehicles for sale. Because the parts and accessories used in this activity are exempt under the resale exemption, no consumer use tax liability exists. There may be a few internal repair orders for company owned vehicles (i.e., a tow truck, parts truck or executive vehicle). Tangible personal property listed on these repair orders is subject to consumer use tax.

I. Flat Fee Charges Dealers may charge a flat fee for all parts, supplies, materials, and labor. The entire charge becomes subject to the tax if there are no separately stated charges for exempt repair or installation labor. Note – effective 07/01/2023, separately stated charges for diagnostic fees are also exempt from the sales and use tax, regardless of whether there is a sale of any repair or replacement part or a shop supply charge.

If shop supplies are included in a flat-fee arrangement but not separately stated on the customer invoice, there is no reliable way for the Department to substantiate that sales tax was collected on the shop supplies. Accordingly, the repair shop is liable for use tax on its tax-free purchase of the supplies (whether transferrable or not).

J. Shop Supplies Effective 07/01/2017, the definition of “retail sale” and “sale at retail” contained in 58.1-602 specifically includes any separately stated charge made for supplies used during automotive repairs, whether or not there is a transfer of title or possession of the supplies, and whether or not the supplies are attached to the automobile. Therefore, automotive repair shops are required to collect and remit the Retail Sales and Use Tax on any separately stated shop supplies charge, regardless of whether title or possession of the supplies passes to the customer. If shop supplies are separately stated on customer invoices, the purchase of such supplies by an automotive repair shop shall be deemed a purchase for resale, and the repair shop will be allowed to purchase such supplies exempt from the tax (see PD 17-138).

The types of items that are considered shop supplies shall be limited to items that are either transferred to the vehicle as a result of the service being performed, or those items that are consumed by the repairing serviceman in direct preparation for, during the course of, or immediately following the repair service performed on vehicles. For instance, shop supplies would include items such as grease, lubricants, sealants, solvents, starting fluid, paper or plastic protecting materials, gasket/weatherproofing materials, solder, drill bits, tape, sanding/grinding/cutting disks and blades, welding rods, oxygen/acetylene for welding, glass cleaner, parts cleaner, fabric cleaner, air tool oil, wheel weights, disposable gloves, single-use garbage bags, shop rags/towels, and degreasing/cleaning soap.

As it would be excessively burdensome to calculate the sales price of various shop supplies, the dealer may calculate the sales price of the supplies by using a reasonable estimate that reflects the sales price. For example, the separate charge for these supplies can be listed on the invoice as a percentage of the total bill.

Any items of tangible personal property that are not consumed in the repair service, or that are consumed by non-repairman employees or customers of the repair shop such as office supplies, service forms, toiletries, reusable cleaning supplies like spray bottles, and waiting room items offered for the customer's convenience are not considered shop supplies.

- K. Purchases by Auto Repair Shops All purchases, except for immediate resale or those placed into an exempt resale inventory, are subject to the Retail Sales and Use tax. Administrative expense items as well as tools, computer diagnostic equipment, and other assets are subject to the tax. In-ground lifts (if installed by the seller) are usually considered real property transactions. Most lifts are now surface mounted and retain their identity as tangible personal property.

If shop supply charges are not separately stated on customer invoices, the repair shop will be liable for the use tax on its tax-free purchases of the supplies (whether transferrable or not).

- L. Disposal Fees All dealers in the business of selling tires, anti-freeze, motor oil, and other like automotive accessories, who charge a disposal fee in connection with the sale of such items, are required to collect the retail sales tax on the disposal fee, even if it is separately stated. By contrast, dealers who provide disposal services totally independent of the sale or provision of tangible personal property are deemed to be providing a nontaxable service (see VTB 94-10).

- M. Diagnostic Fees - Effective 07/01/2023 – under 58.1-609.5(8), there is no tax due on an amount separately charged for labor rendered in connection with diagnostic work for automotive repair and emergency roadside service for motor vehicles, regardless of whether there is a sale of a repair or replacement part or a shop supply charge.

Prior to 07/01/2023 - a diagnostic fee is taxable if the charge is made in connection with the sale of repair or replacement parts. If a repair shop provides diagnostic services to a customer that decides not to have the recommended repairs made, and no property is involved, the diagnostic charge is exempt from the tax (see PDs 13-223, 16-159, & 17-188).

- N. Road Service Charges Some dealers provide mobile vehicle repair services for their customers. This might include repairing a disabled vehicle or replacing a flat tire along a roadside, or providing vehicle maintenance at the customer's location. If the dealer makes separate charges for parts and repair and/or

installation labor, the charge for the repair and/or installation labor is not subject to the tax. Note – effective 07/01/2023, separately stated charges for diagnostic fees are also exempt from the sales and use tax, regardless of whether there is a sale of any repair or replacement part or a shop supply charge. If a lump-sum charge is made for any road service charges that also involve repair or replacement parts, the entire charge is subject to the tax.

In addition to itemized charges for parts and repair and/or installation labor, dealers making mobile repairs may also include separate charges for roadside service, call-out fees, mileage charges, and after hours or weekend charges. These various charges are taxable if made in connection with the sale of parts. The Commissioner has ruled that these miscellaneous road service charges are not part of exempt installation or repair labor because the expenses are incurred prior to, in preparation of, or after the installation or repair has taken place (see PDs 08-67 & 11-74). Note – effective 07/01/2023, separately stated charges for diagnostic fees are also exempt from the sales and use tax, regardless of whether there is a sale of any repair or replacement part or a shop supply charge.

- O. Shop Supply Charges and Otherwise Exempt Services – Whether or not underlying services being rendered are taxable does not impact the taxability of separately stated shop supplies. For example, if a mobile repair service travels to repair a flat tire and decides that the tire does not need to be replaced and can be repaired with a plug (incidental). Separately stated charges for shop supplies in this scenario would comprise a taxable exchange of tangible personal property that falls within the definition of a “retail sale” under 58.1-602, so long as the underlying transaction includes “automotive repairs.” Although the separately stated shop supplies would be subject to the tax, any additional trip or road service charges, or diagnostic fees would not be subject to the tax in this particular situation.

VI. Procedures for an Auto Body Shop

- A. Auto Body Shop Sales Sales of accessories, parts, seat covers, etc., by motor vehicle refinishers and painters are subject to the tax. Examples of taxable parts might include bumpers, grills, headlights, side panels, door panels, hoods, etc. Effective July 1, 2005, Code of Virginia § 58.1-602 was amended to include in the definition of “retail sale” the separately stated charge made for automotive refinish repair materials that are permanently applied to or affixed to a motor vehicle during its repair. Thus, motor vehicle refinishers should also collect sales tax on items such as paint, thinner when used to mix with paint, auto body filler, clearcoat, sealant, and similar items when they apply such items to motor vehicles and separately state the charges for such items.

Effective 07/01/2017, the definition of “retail sale” and “sale at retail” was also amended to specifically include any separately stated charges made for supplies used during automotive repairs, whether or not there is a transfer of title or

possession of the supplies, and whether or not the supplies are attached to the automobile. Therefore, separately stated shop supply charges are also subject to the retail sales and use tax. Auto body shops may purchase shop supplies exempt from the tax if they separately state the shop supply charges on their customer invoices. If they do not separately state shop supplies, they are liable for the use tax on their purchases of shop supplies, regardless of whether they are transferrable or not. Separately stated repair and/or installation charges are exempt from the tax. Note – effective 07/01/2023, separately stated charges for diagnostic fees are also exempt from the sales and use tax, regardless of whether there is a sale of any repair or replacement part or a shop supply charge.

Under 23VAC10-210-1020, there is an “optional” tax treatment for auto body shops to treat themselves as personal service providers and pay the tax on the cost price of paint, clearcoat, sealants, body filler, and similar materials, and not bill tax to their customers. However, if the auto body shop separately states the charges for such automotive refinish repair materials on their customer invoices, they are not entitled to use the optional tax treatment and must treat themselves as retailers. The optional tax treatment also does not apply to sales of repair parts such as bumpers or side panels, which are always subject to the sales tax.

- B. Insurance Transactions The requirement to collect sales tax on repair transactions applies to transactions paid for in whole or in part by insurance companies. Body shops normally give binding estimates which list all parts and repairs that will be required. If additional parts are needed and the parts allocation is increased on the repair order, the retail sales tax applies to the larger amount.
- C. Purchases by Auto Body Shops Tools and equipment, such as frame straighteners, color match computers, and paint booths used in performing the repair work are subject to the tax.

VII. Miscellaneous Procedures

- A. Franchise Dealer Records Franchise dealers (GM, Chrysler, Ford, etc.) are required by the manufacturer to keep its records using a uniform accounting system including the chart of accounts and financial statement formats.
- B. Computerized Sales Records Most motor vehicle dealers are highly computerized. While the original parts tickets, repair orders and other sales documents are usually readily available, it is often easier to examine existing computer printouts. Dealer personnel may be flexible enough to create reports or printouts to provide the exact information which an auditor requests.

- C. Mobile Office Rentals "Mobile office" is excluded from the DMV's definition of "motor vehicle." The DMV imposes a 2% tax on the sales price of each mobile office sold in Virginia, but does not tax the rentals of mobile offices. If the 2% DMV tax is paid at the time of purchase of a mobile office by the owner, then the lease or rental is not subject to the retail sales tax. Conversely, if the 2% DMV tax is not paid at the time of purchase by the owner, then the monthly charges for the mobile office rental are subject to the sales tax. The burden of proof rests with the lessee (person using the mobile office). (See PD 96-157)
- D. Vehicle Pricing Guides Subscription pricing guides (i.e., NADA) which list the current market values of used cars are considered to be publications available for general distribution to the public exempt from sales tax as provided by Code of Virginia §58.1-609.6(3). Subscription sales qualify for exemption from the retail sales tax; however, sales of the guides at retail will remain taxable.
- E. Computer Database Service Charges to a dealer for the lease or rental of computer equipment which provides access to a database which contains information on inventory, pricing, location, and availability of automobiles is not subject to sales tax. The true object of the transactions is the provision of a service. The lease or rental of computer equipment by dealers or their receipt of information on hard copy in connection with this service does not change the exempt status of the transactions. (See PD 88-299)
- F. Alarm Systems and Motor Vehicle Security and Tracking Devices Charges for monitoring services and other services provided on a cost-per-use basis, such as unlocking customer's doors, locating lost vehicles, trip planning and giving directions are exempt from the sales tax. If the system is sold through an independent dealer, and monitored by the alarm system provider, the sale of the security system is subject to the DMV tax if installed prior to titling or to the retail sales tax if installed afterward. However when the provider sells its products (which it monitors) through the mail, it is providing a personal service. (See PD 96-331)
- G. Limited Exemption for Taxicab Operators Code of Virginia §58.1-609.3(10) provides an exemption for parts, tires, meters and dispatch radios sold or leased to taxicab operators for use or consumption directly in the rendition of their services. 23 VAC 10-210-990(E) further limits the exemption by stating that accessories, maintenance materials, and all other tangible personal property purchased by a taxicab operator are subject to the retail sales and use tax.

- H. Special Equipment for Handicapped Drivers Code of Virginia §58.1-609.7(6) provides an exemption for special equipment installed on a motor vehicle when purchased by a handicapped person to enable such person to operate the motor vehicle." Under Virginia's strict interpretation of statutes, the equipment must be purchased by the handicapped person and also enable the person to operate the vehicle. Therefore, the purchase of a wheelchair lift by parents of a handicapped child which allows the child to ride in a vehicle does not fall within the statute.
- I. Litter Tax Motor vehicle dealers are liable for the \$20 annual litter tax since the tax is imposed on any person who wholesales, distributes or retails motor vehicle parts. If the dealer services drink and/or snack machines available to the general public, the additional \$30 tax (imposed on a wholesaler, distributor or retailer of groceries, soft drinks or carbonated waters) applies. If the dealer only receives a commission from a vending company, the additional \$30 would not apply (see VTB 21-1).
- J. Tire Tax Many dealers do not inventory tires and sublet work to retail tire stores. In this case it is proper for the dealer to pay the tire tax to the tire store. If the dealer has significant retail tire sales, a tire tax registration is required.
- K. Farm Licensed Vehicles Sales to a farmer of tires and other accessories for a vehicle specifically licensed by the DMV as a "farm vehicle" are generally exempt (see PD 94-301 for exceptions). Sales to a farmer of tires and other accessories for a vehicle having a normal DMV license (even if used on a farm) are subject to the retail sales tax. (See PD 96-34, 94-301, 05-133)

Field Audit Procedures – Sales & Use Tax

Topic: Newspapers, Magazines, Periodicals and Other Publications

Revised: December 2012

I. References

- A. Code of Virginia:
 - 58.1-609.3.2.(v)
 - 58.1-609.6(3)
- B. Virginia Administrative Code:
 - 23 VAC 10-210-1060 (Newspapers, magazines, periodicals, and other publications)
 - 23 VAC 10-210-920 (Manufacturing and processing)
- C. Public Documents:
 - PD 00-33
 - PD 00-192
 - PD 04-148
 - PD 07-182
- D. Exemption Certificate:
 - ST-11 (Manufacturing)

II. General

- A. **Sales:** The sales and use tax does not apply to the retail sale of any publication issued daily, or regularly at average intervals not exceeding three months, except that newsstand sales of individual copies of the publications are taxable.
- B. **Purchases:** The sales and use tax does not apply to purchases of equipment, printing or supplies used directly to produce a publication as defined below whether sold at retail or distributed at no cost.
- C. **Definitions:**
 - 1. **Publication** shall mean any written compilation of information available to the general public. It does not include general reference materials and their periodic updates.
 - 2. **Newsstand** shall mean a definite place of business at which newspapers or magazines are sold, but does not include coin-operated newspaper boxes.
- D. Advertising inserts or supplements and other printed matter distributed with or as a part of a nontaxable publication are not subject to the tax.
- E. The purchase of other printed matter and materials distributed with or as a part of a nontaxable publication is subject to the tax unless otherwise specifically exempted.

III. Procedures

- A. **Purchases:** The industrial manufacturing exemption is extended to publishers as provided for in the Code of Virginia § 58.1-609.3.2(v) - The retail sales and use tax does not apply to equipment, printing, or supplies *used directly* to produce a publication as described in § 58.1-609.6(3) whether it is ultimately sold at retail or for resale or distribution at no cost.

Publication as described in Code of Virginia § 58.1-609.6(3) is any publication issued daily, or regularly at average intervals not exceeding three months, and advertising supplements and any other printed matter ultimately distributed with or part of such publications. Newsstand sales of the same are taxable.

"Used directly" is defined in 23 VAC 10-210-920 as "those activities that are an integral part of the production of a product, including all steps of an integrated manufacturing process, but not including incidental activities such as general maintenance, management, and administration.

Items used in pre-production activities, or used indirectly in production, cannot be purchased exempt of the tax by publishers.

- B. **Sales:** All newsstand sales of publications are taxable. Sales of back copies of exempt publications by the publisher or his agent are also exempt. In determining if the subscription sale of a publication is exempt, the auditor must refer to the following Procedures:

1. **Exempt Publications:** In order to be exempt from the retail sales and use tax, a newspaper, magazine, periodical or other publication must be a publication, as previously defined, and be issued at the required intervals, i.e.,

a) It must be a compilation of information,

and

b) It must be available to the general public,

and

c) It must be issued daily, or regularly at average intervals not exceeding three months.

A publication which contains articles, news stories, and letters to the editor is consistent with the definition of a publication.

2. **General Reference Materials:** General reference materials and their periodic updates are not considered exempt publications. Reference materials include loose-leaf reference volumes published annually and updated periodically. They also include "reporters" which are devoted to matters of a specialized interest. General reference materials are not limited to publications that are supplemented with periodic updates.

3. Publications on Electronic Media: The exemption for publications is applicable for all electronically delivered subscriptions regardless of frequency.

Additionally, sales or copies of articles sent via electronic means (fax, internet, or other electronic means) are not taxable since no tangible personal property is conveyed in providing this information.

Field Audit Procedures – Sales & Use Tax



Topic: Dealer - Nexus

Revised: December 2012

I. References

A. Code of Virginia:
58.1-612

B. Public Documents:

PD 86-92	PD 94-205	PD 97-459	PD 01-105
PD 89-102	PD 94-266	PD 98-147	PD 01-115
PD 89-171	PD 95-111	PD 98-161	PD 02-113
PD 89-299	PD 95-250	PD 99-26	PD 04-4
PD 91-286	PD 96-112	PD 99-60	PD 04-38
PD 91-314	PD 96-339	PD 99-94	PD 04-129
PD 92-136	PD 97-45	PD 99-187	PD 04-173
PD 93-25	PD 97-81	PD 00-53	PD 05-128
PD 93-141	PD 97-266	PD 00-61	PD 07-37
PD 93-240	PD 97-276	PD 00-77	PD 08-42
PD 94-10	PD 97-306	PD 00-137	PD 09-44
PD 94-62	PD 97-402	PD 00-193	

II. General

- A. Nexus describes the amount and degree of business activity that must be present before a state can require that an entity collect sales and use tax on sales made in that state. The amount of activity or connection that is necessary to create nexus is defined by state statute and/or regulation and case law. When there is a dispute about nexus that is not resolved at the audit appeal level, the case may progress to the state court and then to the Supreme Court of the United States. Sales and use tax nexus decided by the courts is based on the wording of the state's law and how it relates to the Commerce Clause. The Commerce Clause is contained in Article I, Section 8 of the U.S. Constitution. It empowers Congress to regulate interstate commerce and commerce with foreign countries; and is used as a basis for judicial review of state actions by the Supreme Court. At the federal level, the court decides if the state's law is a burden to interstate commerce. Cases appealed to the Supreme Court have only recently begun to deal with the states' power to require companies who have a significant economic impact in their state to register and collect sales and use tax. Nexus requirements are different from state to state.
- B. Sales or use tax is collectible from all persons who meet the definition of a dealer and who have a sufficient activity within the Commonwealth to establish nexus.
- C. Virginia Public Procurement Act; Certain Transactions Prohibited –New – House Bill 2533 (Chapter 994) and Senate Bill 938 (Chapter 1006) prohibit

state agencies from purchasing goods or services from vendors who are required under Virginia's sales tax nexus laws to collect use tax on sales of goods delivered into Virginia but refuse to do so. State agencies are also prohibited from purchasing goods or services from vendors who are affiliated with such businesses. The RAP Unit keeps a list of restricted entities.

Effective Date: July 1, 2003

Code Section Amended: 2.2-4301 Code Section Added: § 2.2-4321.1

Ruling of Commissioner, PD 04-4

- D. E-Commerce Implications - Common situations establishing nexus include physical presence by employees or agents in the state (although sporadic or temporary presence may in some cases not be enough to establish nexus); agency nexus when the out-of-state seller hires in-state third party contractors to perform certain activities; affiliate nexus when the in-state activities of a registered dealer create nexus for an out-of-state affiliate making sales in the dealer's state; and economic nexus when the out-of-state entity poses a significant economic presence in the state through advertising. No nexus cases have been tried in Virginia courts.
- E. Streamlined Sales Tax Project ("SSTP") - Approximately 40 state and local governments have united in a project to protect the local sales tax base against lost revenue due to e-commerce. The Streamlined Sales Tax Project expands the traditional tax nexus rules to encompass remote sellers and encourages remote sellers to comply with their collection responsibility by simplifying and streamlining rules to make compliance simpler. The "Uniform Sales and Use Tax Administration Act" has been passed or is currently under consideration in a number of states. Virginia has not signed off on it as of this writing, but is currently evaluating its provisions and how it would affect our revenue stream.
- F. Dealer/Nexus Checklist Questionnaire – A sample questionnaire is provided on Pages 7–8.
- G. Public Law 86-272 - Taxpayers may refer to P L 86-272 in relation to nexus for sales and use tax. **This statute has nothing to do with sales and use tax nexus.** It relates only to the states' powers to tax income of a company. States are limited by federal statute P L 86-272 when taxing income from activities in the state. Under P L 86-272, the only immunity from the taxation of income stated is for the solicitation of orders for the sale of tangible personal property. Thus, an entity performing services within the state, such as a contractor, may not be protected from the requirements of a state to file income tax returns under this law. Mail order sellers with retail outlets, solicitors, or property within a state are not afforded protection; however, the court has upheld a company's right to communicate with customers in a state by mail or common carrier as part of general interstate commerce without liability.

III. Procedures

- A. Determine if the entity meets the definition of a dealer as listed in the Code of Virginia (§58.1-612), through inquiry and examination of the business activity. Research the entity on the Internet. Many companies have a website that will

list the physical locations of the business and other valuable information about how business is conducted.

The term “dealer” includes every person who:

1. Manufactures or produces tangible personal property for sale at retail, for use, consumption or distribution, or for storage to be used or consumed in this state.
 2. Imports or causes to be imported into this state tangible personal property from any state or foreign country, for sale at retail, for use, consumption or distribution, or for storage to be used or consumed in this state.
 3. Sells at retail or who offers for sale at retail, or who has in his possession for sale at retail, or for use, consumption or distribution or for storage to be used or consumed in this state, tangible personal property.
 4. Has sold at retail, or used, consumed or distributed, or stored for use or consumption in this state, tangible personal property and who cannot prove that the tax has been paid on the sale at retail, the use, consumption, distribution or storage of the tangible personal property.
 5. Leases or rents tangible personal property for a consideration, permitting the use or possession of such property without transfer of title.
 6. Is the lessee or rentee of tangible personal property, and who pays to the owner of the property a consideration for the use or possession of the property without acquiring title.
 7. As a representative, agent or solicitor of an out-of-state principal solicits, receives and accepts orders from persons in this state for future delivery and whose principal refuses to register as a dealer.
 8. Shall become liable to and shall owe this state any amount of tax, whether he holds, or is required to hold, a certificate of registration or not.
- B. If the entity is a dealer, determine if the nexus requirements are met. A dealer shall be deemed to have sufficient activity within the Commonwealth to require registration under §58.1-613 if he:
1. Maintains or has within this Commonwealth, directly or through an agent or subsidiary, an office, warehouse, or place of business of any nature;
 2. Solicits business in this Commonwealth by employees, independent contractors, agents or other representatives;
 3. Advertises in newspapers or other periodicals printed and published within this Commonwealth, on billboards or posters located in this Commonwealth, or through materials distributed in this Commonwealth by means other than the United States mail;

4. Makes regular deliveries of tangible personal property within this Commonwealth by means other than common carrier. A person shall be deemed to be making regular deliveries hereunder if vehicles other than those operated by a common carrier enter this Commonwealth more than twelve times during a calendar year to deliver goods sold by him;
 5. Solicits business in this Commonwealth on a continuous, regular, seasonal, or systematic basis by means of advertising that is broadcast or relayed from a transmitter within this Commonwealth or distributed from a location within this Commonwealth;
 6. Solicits business in this Commonwealth by mail, if the solicitations are continuous, regular, seasonal, or systematic and if the dealer benefits from any banking, financing, debt collection, or marketing activities occurring in this Commonwealth or benefits from the location in this Commonwealth of authorized installation, servicing, or repair facilities;
 7. Is owned or controlled by the same interests who own or control a business located within this Commonwealth;
 8. Has a franchisee or licensee operating under the same trade name in this Commonwealth if the franchisee or licensee is required to obtain a certificate of registration under § 58.1-613; or
 9. Owns tangible personal property that is rented or leased to a consumer in this Commonwealth, or offers tangible personal property, on approval, to consumers in this Commonwealth.
- C. § 58.1-612(D) provides that the following shall not be considered to determine whether a person who has contracted with a commercial printer for printing in the Commonwealth is a "dealer" and whether such person has sufficient contact with the Commonwealth to be required to register.
1. The ownership or leasing by that person of tangible or intangible property located at the Virginia premises of the commercial printer which is used solely in connection with the printing contract with the person;
 2. The sale by that person of property of any kind printed at and shipped or distributed from the Virginia premises of the commercial printer;
 3. Activities in connection with the printing contract with the person performed by or on behalf of that person at the Virginia premises of the commercial printer; and
 4. Activities in connection with the printing contract with the person performed by the commercial printer within Virginia for or on behalf of that person.

NOTE: 2012 Legislative Summary, PD 12-108 (7/1/12). The 2012 Session of the Virginia General Assembly Senate Bill 597 (Chapter 590) creates a rebuttable presumption that an out-of-state dealer has sufficient activity in Virginia to require the dealer to register and collect retail sales and use tax if a commonly controlled person maintains a distribution center, warehouse, fulfillment center, office, or similar location in Virginia that facilitates the

delivery of tangible personal property that is sold by the out-of-state dealer. Affected dealers can rebut this presumption by demonstrating that the activities conducted by the commonly controlled person in Virginia are not significantly associated with the dealer's ability to establish or maintain a market in the Commonwealth for the dealer's sales. The Act defines "commonly controlled person" as "any person that is a member of the same controlled group of corporations, as defined in § 1563(a) of the Internal Revenue Code, as the dealer or any other entity that, notwithstanding its form of organization, bears the same ownership relationship to the dealer as a corporation that is a member of the same controlled group of corporations."

Effective Date

This Act becomes effective on the earlier of September 1, 2013 or the effective date of federal legislation authorizing states to require remote sellers to collect taxes on goods shipped to in-state purchasers. The Act specifies that if the federal legislation is enacted prior to August 15, 2013, and the effective date of the federal legislation is after September 1, 2013, but on or before January 1, 2014, the Act becomes effective on January 1, 2014.

Accordingly, the following wording would replace section C in these audit procedures and replace section D in § 58.1-612:

A dealer is presumed to have sufficient activity within the Commonwealth to require registration under § 58.1-613 (unless the presumption is rebutted as provided herein) if any commonly controlled person maintains a distribution center, warehouse, fulfillment center, office, or similar location within the Commonwealth that facilitates the delivery of tangible personal property sold by the dealer to its customers. The presumption in this subsection may be rebutted by demonstrating that the activities conducted by the commonly controlled person in the Commonwealth are not significantly associated with the dealer's ability to establish or maintain a market in the Commonwealth for the dealer's sales. For purposes of this subsection, a "commonly controlled person" means any person that is a member of the same "controlled group of corporations," as defined in § 1563(a) of the Internal Revenue Code of 1954, as amended or renumbered, as the dealer or any other entity that, notwithstanding its form of organization, bears the same ownership relationship to the dealer as a corporation that is a member of the same "controlled group of corporations," as defined in § 1563(a) of the Internal Revenue Code of 1954, as amended or renumbered.

- D. § 58.1-612(E) addresses, in part, the "dormant commerce clause". The U. S. Supreme Court's interpretation of the power given to Congress in the U. S. Constitution to regulate commerce among the states has been construed by the court to mean the limiting of the taxing powers of the states, even though Congress has not affirmed this interpretation. The court has used the Interstate Commerce Clause to prevent states going beyond their state borders placing an "undue burden" of collecting sales and use tax on remote sellers and to avoid "double taxation". Over the years, with the invention of the computer and other technological advances, collecting tax is not so burdensome anymore. Further, with commerce being expanded through the Internet, states have seen huge economic shifts attributable to these technological advances that create an unfair disadvantage to retailers who

are required to collect tax due to their physical presence in a state. This section provides that in addition to the jurisdictional standards contained in subsection C of §58.1-612, nothing contained in this code section (other than subsection regarding advertising) “shall limit any authority which this Commonwealth may enjoy under the provisions of federal law or an opinion of the United States Supreme Court to require the collection of sales and use taxes by any dealer who regularly or systematically solicits sales within this Commonwealth”.

Further, although a broadcaster, printer, outdoor advertising firm, advertising distributor, or publisher in Virginia accepts advertising contracts from out-of-state entities, if the Virginia seller broadcasts, publishes, or displays or distributes paid commercial advertising in this Commonwealth which is intended to be disseminated primarily to consumers located in this Commonwealth, he must collect and report the applicable tax. This closes the loophole, so to speak, of § 58.1-612(D) explained earlier. While the out-of-state advertiser may not meet dealer/nexus qualifications, he must pay the tax on printed advertising directed at Virginia consumers.

- E. Identify relationships between affiliated businesses, parents and subs, etc. and gather information about how they interact with each other. This interaction may be critical to establish nexus. For instance, do in-state dealers receive or exchange goods ordered from catalogs or internet? Do in-state dealers advertise for their affiliates in the store, on their cash register tapes, bags, or as a part of their newspaper advertising? Document your research and your discussions with the entity. Provide the entity with ruling letters and language from case law to support your conclusion. Give them time to digest and discuss with their legal counsel the information that they have been given if they need it. Respond to any questions that arise.

Request that they register for the future and negotiate what will be done for the past. Discuss with supervision whether a three or six year statute will apply and what steps will be taken if an agreement cannot be reached on the handling of the past.

- F. If Virginia tax has been collected in error on a Virginia sale, the entity is automatically a dealer under §59.1-612 B (8). The tax must be paid to Virginia (Code of Virginia §58.1-625).

SAMPLE DEALER/NEXUS QUESTIONNAIRE

- 1) Is the business registered for any other Virginia tax such as withholding or corporate?
- 2) Has the business filed any types of returns with VA (specify type of tax)?
- 3) Is the business registered with the State Corporation Commission, State Contractors Board, or any locality (Business License)?
- 4) Is there an office, agency, warehouse, or other business location owned or leased in VA?
- 5) Does the business have employees, representatives or independent contractors who perform any of the following activities in VA?
 - a) Solicit orders with or without authority to approve?
 - b) Manage territories or perform marketing surveys?
 - c) Sell tangible personal property?
 - d) Make collections on regular or delinquent accounts?
 - e) Repossess items or property of the business?
 - f) Offer technical assistance and training to customers before or after the sale?
 - g) Repair, service, or replace faulty or damaged goods?
 - h) Install or assemble its products?
 - i) "License" software for use in the state?
 - j) Oversee the installation of the business' products by its customers or users of its products?
 - k) Pick up damaged or returned merchandise from customers?
 - l) Coordinate delivery of merchandise?
 - m) Deliver replacement parts?
 - n) Conduct credit investigations or arrange for credit and financing for purchasers of its products?
 - o) Resolve or assist in resolving any product, credit, shipping or similar complaint arising from the purchase or use of its products?
 - p) Maintain displays of products or refill displays?
 - q) Accept returned merchandise for customers?
 - r) Collect deposits on sales?
 - s) Make "on the spot" sales of company products?
 - t) Carry out engineering or design functions?
 - u) Advise customers or distributors as to minimum inventory levels; remove obsolete, damaged or outdated goods?
 - v) Receive and resolve complaints?

- 6) Does the business own or lease real property in VA?
- 7) Does the business own or lease tangible personal property located in VA?
- 8) Does the business rent or lease tangible personal property to others who then use the property in VA?
- 9) Does the business license intangible property for use in VA?
- 10) Does the business license software for use in VA?
- 11) Does the business maintain a telephone answering service in VA?
- 12) Does the business have a standard form of written agreement with sales representatives? If so, please provide a copy.
- 13) Is the business a member of an affiliated group of corporations? If so, does the business file a consolidated or combined return in VA?
- 14) Does the business have display merchandise in leased space in VA?
- 15) Do employees have samples in VA? If yes, then what is the average value of samples in VA?
- 16) Does the business provide sales or service manuals to customers, distributors, or agents?
- 17) Does the business advertise in VA? If so, what kinds of advertising media are used?
- 18) Does the business do any cooperative advertising in VA?
- 19) Does the business have any employees or representatives who use their home in VA:
 - a) As a business address?
 - b) To receive business calls?
 - c) To store inventory or sold goods until delivery?
 - d) To maintain books/records?
 - e) To house company property?
- 20) Are VA independent contractors or representatives reimbursed for expenses such as telephone, fax or utilities?
- 21) Are home numbers listed in local advertisements of the business?
- 22) Do employees of the company solicit orders for the sale of:
 - a) Real estate?
 - b) Services?
 - c) Intangible property?
- 23) Does the business perform construction contracts in VA?
- 24) Is the business listed in any VA telephone directories?
- 25) Does the business have any consigned inventory in VA?

- 26) Does the business operate a mobile store in VA?
- 27) Has the business previously filed VA income tax returns?
- 28) Does the business maintain a security interest in property until the contract price or amount borrowed has been paid?
- 29) Do employees investigate, recommend, or appoint potential dealers, agents, or distributors of the company in VA?
- 30) Do employees ever check the inventories of customers or distributors in VA?
- 31) Do employees authorize credits, warranty adjustments or repairs in VA?
- 32) Does the business have agents or independent contractors selling products in VA?
If so, are they allowed to sell or promote competitors' services?
- 33) Does the business select repair facilities in VA where customers can have products serviced or repaired?
- 34) Is the business a partner, limited partner or affiliate of any entity that has operations, conducts business, or owns real property in VA?

Field Audit Procedures – Sales & Use Tax



Topic: Nonprofit Organizations

Revised: September 2016

I. References

- A. Code of Virginia:
58.1-609.11, Subsections A through G
- B. Virginia Administrative Code:
23 VAC 10-210-1070 – 23 VAC 10-210-1072
- C. Virginia Tax Bulletins:
VTB 08-11
VTB 09-8
VTB 16-3
- D. Exemption Certificates:
Numbered exemption certificate issued by the Department

II. General

- A. Legislation enacted by the 2003 General Assembly, effective July 1, 2004, authorized the Department of Taxation to implement a new process by which nonprofit organizations obtain sales and use tax exemptions. Exemptions in existence on June 30, 2003 were grandfathered until a set expiration date between July 1, 2004 and July 1, 2008, as shown below. All organizations must reapply for an exemption under the new process when their exemption expires. If their applications are approved, the organizations are issued a nonprofit letter of exemption.

Exempt nonprofit organizations fall into four broad categories:

- 1. Education
- 2. Medical
- 3. Civic and community service
- 4. Cultural

The expiration schedule for nonprofit organizations that held an exemption on June 30, 2003 is as follows:

- Civic and community service (1st Half): July 1, 2004
- Civic and community service (2nd Half): July 1, 2005
- Cultural and miscellaneous: July 1, 2006
- Educational: July 1, 2007
- Medical: July 1, 2008

- B. A nonprofit organization reapplying for an exemption must meet all the applicable criteria below in order to qualify for an exemption.

1. The organization must be exempt from federal income taxes under either §§501(c)(3) or 501(c)(4) of the IRC. The organization may qualify if it has annual gross receipts of less than \$5,000 and is organized for at least one of the purposes set forth in IRC §§501(c)(3) or(c)(4).
 2. The organization's administrative expenses, including salaries and fundraising expenses, must not exceed 40% of its annual gross revenue.
 3. The organization must provide proof of compliance with Chapter 5 of Title 57 (relating to solicitation of contributions) of the Code of Virginia for organizations subject to these provisions.
 4. An organization with annual gross revenues of \$750,000 or greater in the previous year, must provide a copy of its financial review performed by an independent certified public accountant. For an organization with annual gross revenues of \$1,000,000 or greater in the previous year, the Department of Taxation will determine whether the organization must provide a copy of a financial review or a full financial audit performed by an independent certified public accountant.
 5. If the organization is required to file Federal Form 990 or 990EZ, it must provide a copy of the form to the Department of Taxation.
 6. If the organization is not required to file Form 990 or 990 EZ, it must provide 1) a list of the Board of Directors, or other responsible agents of the organization composed of at least two individuals, with physical addresses where the individuals can be found, and 2) the location where the financial records of the organization are available for public inspection.
- C. The duration of each exemption granted by the Department of Taxation shall be for a period of five to seven years. The new exemption will cover purchases of tangible personal property only, with the following exceptions:
1. Any nonprofit entity granted an exemption from paying sales and use tax is exempt from collecting sales and use tax if it is within the same class of organizations that were exempt from collecting sales and use tax on June 30, 2003.
 2. Any nonprofit entity granted an exemption from paying sales and use tax on purchases of tangible personal property, which was exempt as of June 30, 2003 from paying sales and use tax on its purchases of taxable services, shall continue to be exempt from paying sales and use tax for the purchase of services.
 3. Effective October 1, 2008, any organization exempt from federal income taxes under IRC §501(c) can make sales of 1) food, prepared food and meals and 2) sales of tickets to events that include the provision of food, prepared food and meals without collecting tax provided the following requirements are met:
 - a) The organization must not be required to register as a dealer

- b) The organization must pay sales tax to its vendors.
- c) The organization must not hold such events on more than 12 occasions per year.
- d) The organization must use any profits from the sales of food or event tickets solely to support the organization or for donation to another IRC §501(c) organization
- e) The organization must maintain records for three years after each event to verify these requirements.

This exemption applies to all nonprofit organizations. An organization may count a fundraising occasion as one event, provided it does not extend beyond a seven-day consecutive period. Every seven-day consecutive period thereafter shall constitute an additional event.

- 4. Effective July 1, 2009, any organization exempt from federal income taxes under either §§501(c)(3) or 501(c)(4) of the IRC, or who has annual gross receipts of less than \$5,000 and is organized for at least one of the purposes set forth in IRC §§501(c)(3) or(c)(4), can make sales of 1) food, prepared food and meals and 2) sales of tickets to events that include the provision of food, prepared food and meals without collecting tax, provided it does not hold such events on more than 23 occasions per year.

This exemption applies to any nonprofit organization eligible to be granted a nonprofit exemption on its purchases pursuant to Code of Virginia §58.1-609.11. However, the organization is not required to apply for or be granted a letter of exemption in order to qualify for this exemption.

D. CHANGE IN POLICY EFFECTIVE APRIL 22, 2016 for certain Nonprofit organizations.

A. Services Provided in Connection with Exempt Food Sales Are Exempt; Accommodations Remain Taxable.

- 1. Effective for purchases made on and after April 22, 2016, nonprofit organizations, state and local governmental entities, and churches may use their respective nonprofit exemption certificate, governmental exemption certificate, Form ST-12, and self-issued exemption certificate, Form ST-13A to purchase prepared foods, catering and related services provided in connection with the sale of food exempt of the sales and use tax. The Department will no longer deny nonprofit organizations, state and local governmental entities, and churches an exemption on their purchases of meals, catering services, or other services provided in connection with the provision of food on the basis that the entity is purchasing a taxable service. Eligible nonprofit entities and state and local governments purchasing food, meals, and associated services for consumption by individuals must satisfy the Department's new use and consumption test explained below, in order for the exemption to apply.
- 2. Churches using a self-issued ST-13A exemption certificate and federal government entities are not required to satisfy the new use and

consumption test in order to purchase meals, catering, and related services exempt of the tax. Churches using the limited exemption certificate must satisfy the requirements set forth in *Va. Code* § 58.1-609.10(16) to qualify for exemption.

3. Federal governmental entities and employees traveling on government business remain exempt from the tax on their purchases of meals and catering, provided payment for the meals is made directly by the federal government pursuant to a required official purchase order to be paid out of public funds.
4. State and local governmental entities, nonprofit organizations, and churches using the limited, self-issued exemption certificate will continue to be liable for the Retail Sales and Use Tax on purchases of taxable accommodations furnished for fewer than 90 continuous days and other taxable services that are not furnished in connection with the provision of meals.

B. Use or Consumption Requirement for Governmental Entities and Nonprofits Purchased for Individual Consumption.

1. Under the new policy, the Department will use a bright-line test to determine whether a state and local governmental entity or nonprofit organization's purchase of food or other tangible personal property, prepared meals, catering or related services satisfies the statutory "use or consumption" requirement when purchased for consumption by individuals. Under this test, nonprofit organizations and state and local governmental entities must demonstrate the following:
 - The provision of the applicable prepared meals, catering or services furthers a function, mission, service or purpose of the governmental or nonprofit entity; and
 - The charge for the food, meals or catering is billed to and paid for by the
 - entity claiming exemption from the tax with payment drawn from the entity's account, rather than using cash or an individual's account; and
 - The entity claiming the exemption determines to whom, when and how the meals or food are served and consumed.

III. Procedures

- A. Prior approval from the Director of Field Audit is required before initiating an audit of a nonprofit organization. The organization should have a copy of its (SE) exemption letter. The letter indicates the entity's exemption number, which is in the format: SE followed by FEIN number (9 digits), followed by F (legal FEIN) or C (created #), followed by the expiration date (8 digits (mo/day/year) with no spaces or hyphens within the number.

Example: SE9900112223CO6302008

The letter will indicate the extent of the exemption:

1. Exempt purchases of tangible personal property

2. Exempt sales
3. Exempt purchases of taxable services.

The auditor should examine sales and purchases to determine if the nonprofit entity is making exempt purchases and sales in accordance with its specific exemption.

- B. When reviewing exempt sales made to nonprofit entities, the vendor should have a copy of the (SE) exemption letter and/or a valid ST-13 Certificate of Exemption on file.

If the vendor does not have a copy of the exemption letter, check the nonprofit database to determine if an exemption has been granted to the organization. If the organization is not on the database, sales made to this entity after the expiration date on Page 1 are taxable. Sales made after the expiration date on the exemption letter are also taxable.



Field Audit Procedures – Sales & Use Tax

Topic: Occasional Sales

Revised: December 2012

I. References

- A. Code of Virginia:
58.1-602, 58.1-609.10(2)
- B. Virginia Administrative Code:
23 VA 10-210-570, 23 VAC 10-210-1072, 23 VAC 10-210-1080
- C. Tax Bulletins
VTB 08-11 09-8
- D. Public Documents:

PD 91-290	PD 93-164	PD 93-178	PD 94-21
PD 94-35	PD 94-134	PD 94-143	PD 94-61
PD 95-21	PD 95-79	PD 95-302	PD 96-5
PD 96-75	PD 97-199	PD 00-1	PD 00-126
PD 01-75	PD 02-96	PD 03-4	PD 03-51
PD 04-56	PD 04-55	PD 04-134	PD 04-214
PD 05-21	PD 06-67	PD 06-96	PD 06-129
PD 07-08	PD 08-118	PD 09-166	PD 09-186
PD 10-87	PD 10-210	PD 10-151	PD 10-247
- E. Court Case – *Steuart Petroleum Co. v. Virginia Department of Taxation*

II. General

- A. The tax does not apply to an occasional sale provided the sale or exchange is not one of a series of sales or exchanges sufficient in number, scope, and character to constitute an activity requiring the holding of a certificate of registration.
- B. The occasional sale exemption is based on the premise that persons not regularly engaged in making retail sales should not be required to register and collect the tax on occasional or isolated sales. A fundamental characteristic of an occasional sale is that it lacks continuity and regularity and it occurs without being expected or without design.
- C. The occasional sale exemption is not founded on nexus or other issues relating to interstate commerce, but rather on limited sales activity. Nexus is an issue that relates to a seller's obligation to collect the tax. The absence of nexus does not in itself negate the purchaser's responsibility to pay the use tax if such is due.

- D. Occasional sale is defined as one of the following:
1. A sale by a person who is engaged in sales three or fewer separate occasions per calendar year. Sales at fairs, flea markets, carnivals and circuses are not occasional sales.
 2. A sale of tangible personal property not held or used by the seller in the course of an activity for which he is required to hold a certificate of registration.
 3. The sale or exchange of all or substantially all the assets of any business.
 4. The reorganization or liquidation of any business.
- E. Effective October 20, 2008, the occasional sales exemption was expanded to include sales of food, prepared food, and meals, and tickets to events that include the provision of food by entities that are exempt from federal income taxation under *Internal Revenue Code (IRC) 501 (c)*. provided all of the following:
1. The entity is not required to be registered to collect sales tax due to its normal business activities.
 2. The entity pays sales tax on the purchase price of the food to be resold.
 3. The entity limits such events to 12 or fewer occasions a year.
- Effective July 1, 2009, the occasional sales exemption was further expanded for entities exempt from federal income taxation under (IRC) 501 (c) 3 or (c) 4. Such nonprofit organizations are eligible to be granted an exemption on their purchases of tangible personal property under *Va. Code § 58.1-609.11*. Provided, again, that they are not required to be registered, these entities may make both exempt purchases of food and foodstuffs and exempt sales of food and tickets to events that include the provision of food, provided that such sales take place on 23 or fewer occasions in a calendar year.
- F. If a transaction qualifies as an occasional sale, the purchaser is not liable for any use tax.
- G. A purchaser meets the definition of a dealer when he causes tangible personal property to be imported into the Commonwealth for his own use or consumption. Generally no occasional sale exemption is allowed on purchases from out-of-state. (See PD 93-164.)
- H. The brokered rental of private residences for 2 weekends per year qualifies as an “occasional sale” not subject to sales tax. (See PD 07-08 - This ruling related to NASCAR race weekends in Bristol, Martinsville, and Richmond.)
- I. The occasional sale exemption is denied to auctioneers when selling the entire contents of storage lockers to satisfy liens against unpaid locker rental. (See PD 10-247.)

III. Procedures

A. Analyze the transaction. Obtain detailed information from the taxpayer regarding the terms and nature of the sale. Determine if the transaction meets the definition of an occasional sale. If the auditor is unable to make a determination, the transaction should be taxed, and the taxpayer should request a ruling from the Tax Commissioner.

B. The transaction must first meet the "number, scope, and character" criteria:

1. The taxpayer must generally make sales on three or fewer occasions each year. (See II.E above regarding nonprofit organizations)

If the taxpayer has made more than three sales in a calendar year, the auditor must determine if the sales occurred unexpectedly and without design, and were truly occasional in nature. If so, the taxpayer becomes a dealer and is required to collect tax beginning on the date of the fourth sale. If not, the taxpayer is a dealer effective on the date of his first sale.

2. If the transaction is an integral, although infrequent, part of the taxpayer's activities, it may not qualify as an occasional sale.
3. The duration of a sale must be for no more than a few days. Otherwise the taxpayer is deemed a retailer as he may be in competition with businesses or other organizations that are required to collect sales tax. (See II.E above regarding sales by nonprofit organizations)
4. A sale otherwise defined as an occasional sale will not be exempt if it does not meet the "number, scope, and character" criteria. The Department has historically determined that if the sale of all or substantially all the assets of a business requires several transactions over an extended period of time to many different purchasers, it does not qualify as an exempt occasional sale. The Department has relied on the "three or fewer" sales provision to deny the occasional sale exemption in many such instances.

In the *Steuart Petroleum* court case, the Court stated that an evaluation of the scope and character of such transactions should be conducted in order to place the number of asset sales in their proper context. In the instant case, all the assets of a division were sold pursuant to an orderly plan of liquidation - there was no piecemeal disposition. Five packages, as determined by geographic location, were sold over a nine-month period - there were not dozens of buyers bidding over several years.

The Court determined that the scope and character of these sales fall within the intent of the General Assembly to shield such transactions from sales tax. As a result the orderly liquidation of a business over a twelve-month period qualifies for the occasional sale exemption.

C. A registered dealer is not allowed an occasional sale exemption for the mere fact that the article sold differs in the type or class from the products he normally sells. For example, a dealer who operates a convenience store is not allowed an occasional sale exemption for the sale of a cash register.

The property sold must not be used in the activity for which the dealer is required to be registered. For example, a bank which holds a certificate of registration for the sale of checks, checkbooks, and reclaimed property may make an exempt occasional sale of data processing equipment used by its Information Services Division.

In the case where a lessor sells all of its leased equipment, which represents all of the lessor's assets, to the lessee, the terms of the lease agreement will determine if the sale qualifies as an occasional sale. If the equipment is sold through some provision in the lease agreement allowing for the sale of the leased equipment prior to the end of the lease period, it would not qualify as an occasional sale.

If the sale is made outside the terms of the lease contract, it would qualify as an occasional sale as the equipment represented all the assets of the lessor's leasing business.

- D. The sale or exchange of all or substantially all the assets of any business is an exempt occasional sale if the sale represents the sale of all or substantially all the assets of the seller's business **in Virginia**. The seller may continue to operate like businesses in other states.

A separate legal entity is a separate and distinct business. For example, a corporation may make an exempt occasional sale of all its assets in Virginia, although it holds an interest in a joint venture which continues to operate in Virginia.

A disposition of a separate and distinct activity of a multifaceted business operation may qualify as the sale of all or substantially all the assets of a business. In determining if a division of a business is separate and distinct from the business, certain criteria must be met.

1. Each division must have a completely separate set of books which are separately maintained.
2. Separate bank accounts must be maintained.
3. Employees must be active in only one division.
4. Divisions must be separately housed.
5. Each division must have its own fixed assets which are not used interchangeably.

- E. The transfer of assets from one business to newly-formed subsidiaries in exchange for all of the issued and outstanding shares of stock of those subsidiaries qualifies for non-recognition of income under Internal Revenue Code (I.R.C.) Section 351. This tax-exempt reorganization of assets for stock is a qualifying "reorganization" for purposes of the occasional sale exemption. This includes the sale of a business through a series of transfers, each of which qualifies for non-recognition of income under I.R.C. Section 351 as the tax-exempt reorganization of assets for stock.



Field Audit Procedures – Sales & Use Tax

Topic: Penalties and Interest

Revised: December 2012

I. References

- A. Code of Virginia:
 - 58.1-635 (Penalties for failure to file return)
 - 58.1-1840.1F.1. (Virginia tax amnesty program post-amnesty penalty)
- B. Virginia Administrative Code:
 - 23 VAC 10-210-2030 (Penalties and interest; generally)
 - 23 VAC 10-210-2032 (Penalties and interest: audits).
- C. Public Documents:
 - PD 00-98 PD 00-115 PD 02-006
 - PD 04-76 PD 10-166 PD 10-247
 - PD 11-184

II. General

- A. The application of interest to all audit deficiencies is mandatory. It accrues at the rate established in Section 6621 of the Internal Revenue Code, as amended, plus 2.0%.
- B. When any dealer fails to make any return and pay the full amount of the tax due, penalty is to be added to the tax in the amount of six percent if the failure is for not more than one month, with an additional six percent for each additional month, or fraction thereof, during which the failure continues, not to exceed thirty percent in the aggregate. In no case, however, shall the penalty be less than ten dollars and such minimum penalty shall apply whether or not any tax is due for the period for which such return was required.
- C. Penalty is typically not applied to first generation audits unless:
 - 1. the taxpayer was previously notified in writing, but failed to follow instructions; or
 - 2. the taxpayer collected tax, but failed to remit it; or
 - 3. indications of fraud exist.
- D. The application of penalty on second and subsequent audits is generally based upon the taxpayer's compliance ratio.
 - 1. The compliance ratio is calculated by dividing the measure reported by the total of the measure reported plus the measure found. Measure reported does not include any measure on which tax was paid directly to the vendor by the taxpayer. The purpose of the use tax compliance ratio is to measure how well a taxpayer complied with the Virginia tax laws requiring the accrual and remittance of the tax on untaxed purchases.

2. On second generation audits the taxpayer's compliance ratios must meet or exceed 85% for sales tax and 60% for use tax in order to avoid the application of penalty.
3. On third and subsequent audits, penalty will apply unless the taxpayer's compliance ratios meet or exceed 85% for both sales and use taxes.
4. The taxpayer can apply for penalty relief for all second and subsequent audits using the alternative method of computing use tax compliance. The alternative method allows taxpayers to include the measure upon which sales tax was paid to vendors in the compliance ratio calculation. The alternative method can be applied for all retail sales and use tax audit assessments issued on and after October 1, 1999. The compliance ratio is calculated by dividing the use measure reported plus the sales tax measure paid to vendors by the use measure reported plus the sales tax measure paid to vendors plus the deficiency. It is the taxpayer's responsibility to compute the Alternative Method calculations and provide the auditor with documentation supporting the computation within 60 days of the audit assessment. The taxpayer must compute the ratio based on a review of the same period used to compute the compliance ratio. If the compliance ratio computed under the alternative method meets or exceeds the established threshold the penalty will not apply and should be abated.

E. Penalty may be waived:

1. on audit deficiencies occurring in new areas not covered on prior audits.
2. in instances where the taxpayer has relied on written information provided by the Department.
3. in instances where exceptional mitigating circumstances exist.
4. if the taxpayer chooses to use the Alternative Method of Computing the Use Tax Compliance. It is the taxpayer's responsibility to complete the Alternate Method calculations and provide the auditor with documentation supporting the computation within 60 days of the audit assessment. The Alternate Method can only be used on assessments issued on and after October 1, 1999.

F. Fraud penalty of 50% will apply in cases where the taxpayer filed false or fraudulent returns with the intent to defraud the Commonwealth. The Code of Virginia states that under reporting gross sales, gross proceeds, or cost price by 50% or more is prima facie evidence of intent to defraud.

If a taxpayer does not register to collect sales tax, but collects it, and does not remit it, the fraud penalty will apply.

III. 2009 Virginia Tax Amnesty Program

A. Background:

The 2009 Virginia General Assembly passed legislation creating an Amnesty Program that was held from October 7, 2009 through December 5, 2009. (See also PD's 09-140 and 09-175 relating to Amnesty Procedures). Any taxes owed, whether previously billed or not, were eligible for this program (if you were an amnesty eligible taxpayer) provided that the tax period was for May 2009 or prior (calendar year 2007 and prior for Individual and Corporate Income, and calendar year 2008 and prior for Litter tax) and the bill, if assessed, was at least 90 days old as of the first day of Amnesty.

Any Amnesty eligible amounts that were not satisfied during the Amnesty window may be assessed a Post-Amnesty Penalty that is equal to 20% of the outstanding tax amount. An audit assessment which contains outstanding tax liabilities that would have been eligible for Amnesty (including Consumer Use tax) may be subject to the Post-Amnesty Penalty because the liability was not reported or paid during Amnesty. The post-amnesty penalty applies to unpaid amnesty eligible taxes only, not to outstanding balances of penalties or interest. The post-amnesty penalty is in addition to all other penalties.

B. Application of Post-Amnesty Penalty:

The Post-Amnesty Penalty of 20% is in addition to other statutory penalties for late or fraudulent filing and any prior amnesty penalties assessed. Subject to the Procedures established by the Tax Commissioner for audits, the Post-Amnesty Penalty is applicable as follows:

1. Amnesty eligible tax liability assessed with standard and/or fraud penalty will have an additional 20% post-amnesty penalty assessed.
2. Amnesty eligible tax liability assessed without standard and/or fraud penalty will have an additional 20% post-amnesty penalty assessed if the amnesty eligible tax amount is not paid within 30 days of the audit assessment date.

Field Audit Procedures – Sales & Use

Tax Topic: Prefabricated and Modular Homes

Revised: December 2012

I. References

- A. Code of Virginia:
58.1-602 and § 58.1-610.1
- B. Virginia Administrative Code:
23 VAC 10-210-2080
- C. Virginia Tax Bulletin:
VTB 00-3
- D. Public Documents:
PD 00-109 Reduced Tax Treatment for Modular Buildings
PD 10-268 Sales to Modular Building Dealers
- E. Exemption Certificates:
ST-10 (Resale)
ST-11 (Manufacturing)

II. General

- A. Retail sales of modular buildings by modular building manufacturers and modular building retailers are subject to sales tax on 60% of the sales price. A retail sale occurs when the modular building is sold without installation to the final consumer.
- B. Modular buildings are comprised of one or more sections, primarily built in a factory setting, and transported to the site of final assembly to be affixed to a permanent foundation. Modular buildings do not include “mobile offices” or manufactured homes (formerly known as “mobile homes”).
- C. Modular building manufacturers are engaged in the fabrication, construction and assembling of building supplies and materials into modular buildings at a location other than the site where the modular building will be assembled to the permanent foundation.
- D. When a modular building manufacturer contracts to furnish and install a modular building, the manufacturer is deemed the final consumer of prefabricated components and other materials incorporated into the modular building. In such instances, purchases are subject to sales tax based on 100% of the cost price of the materials and components.
- E. A tax credit is available for only modular building manufacturers in instances where the manufacturer sells a modular building without installation and has paid sales or use tax on the cost price of materials incorporated into the modular building. The manufacturer must collect the sales tax based on 60% of the retail sales price, and may claim a credit against such tax collection on

its sales tax return for the amount of sales or use tax paid on the cost of materials for this sale.

III. Procedures

- A. **Sales:** Sales of modular buildings without installation, other than for resale, are subject to sales tax on 60% of the retail sales price. Sales of set-up components, such as roofing materials, siding, boards, adhesive, nails, screws, etc. are subject to sales tax based on the 100% of the sales price when such components are sold independent and separate from the sale of a modular building.

When a manufacturer who primarily manufactures modular homes with installation makes a sale without installation, a credit is allowed for taxes paid on the cost price of materials used as set out in Section II E above.

For sales of modular buildings with installation, all manufacturers, including those who primarily manufacture modular homes for sale without installation are liable for sales and use tax on the total cost price of materials used. [If the actual cost cannot be determined, such cost may be estimated using available records or if no means exist to make a reasonably close calculation of the actual cost.]

- B. **Purchases:** The exemption for items used directly in the manufacture of modular buildings would apply to purchases by manufacturers primarily making sales without installation. Purchases by manufacturers who primarily make sales with installation and are thus treated as consuming contractors would be subject to sales tax.

Field Audit Procedures – Sales & Use Tax

Topic: Printing and Printers

Revised: December 2012

I. References

- A. Code of Virginia:
 - 58.1-602
 - 58.1-609.3(2)
 - 58.1-609.3(11)
 - 58.1-609.6(3)
 - 58.1-609.6(4)
- B. Virginia Administrative Code:
 - 23 VAC 10-210-3010
- C. Virginia Tax Bulletin:
 - VTB 95-5
- D. Public Documents:

PD 82-26	PD 88-50	PD 89-159	PD 90-79
PD 95-185	PD 95-216	PD 95-218	PD 96-33
PD 96-180	PD 96-278	PD 96-304	PD 96-324
PD 96-327	PD 96-380	PD 97-54	PD 97-65
PD 97-387	PD 98-127	PD 00-192	PD 00-214
PD 01-22	PD 01-35	PD 02-27	PD 02-110
PD 04-101	PD 10-72	PD 10-73	
- E. Exemption Certificate:
 - ST-10A
 - ST-11

II. General

- A. Sales of printing delivered in Virginia are generally subject to the sales tax. However, an exemption exists for certain printed materials, other than administrative supplies, stored for 12 months or less in Virginia for distribution in other states.
- B. The printing of tangible personal property for sale or resale is considered industrial manufacturing and, as a result, the exemption for industrial materials applies (VAC 10-210-920).

III. Procedures

- A. There are three types of printing defined in VAC 10-210-3010: Custom printing; Consumer printing; and Publisher printing. Each classification has its own tax Procedures.
 - 1. Custom printing is the production or fabrication of printed matter in accordance with customer specifications for the customer's own use or consumption. Generally, the sale of custom printing represents the

taxable sale of tangible personal property. The tax is computed on the total invoice charge made on the transaction including any service charges made in connection with the sale of the printed matter (e.g. plate charges, imprinting charges, folding charges, etc.). The tax is also applicable to custom printing charges in instances where the customer furnishes the printing stock.

Purchases by the printer of items which become part of the printed matter for sale or resale are not subject to the tax (e.g. ink, printing stock, staples, stapling wire, binding twine, glue, etc.). Purchases by the printer of items used directly in the production of custom printing are similarly not subject to the tax (e.g. printing plates, dies and mats, printing presses and their repair parts, typesetting, etc.). The tax does not apply to paper, ink, and other materials furnished to a custom printer that will become a component or ingredient part of products fabricated by the printer.

2. Consumer printing is the production or fabrication of printed matter for one's own use or consumption and not for resale. The manufacturing exemptions do not apply to consumer printing since there is no sale or resale. Although the manufacturing exemptions do not apply, other exemptions may be applicable to the purchases made by individuals engaged in consumer printing (e.g. certain printed materials when stored for 12 months or less in Virginia and distributed for use outside the state).
3. Publisher printing is the printing of books, newspapers, magazines or other periodicals for sale or resale by the publisher-printer and includes the printing of a "publication" (as defined in VAC 10-210-1060) which is distributed free of charge. A publisher-printer making retail sales of books, etc., must add tax to the charge. However, the sale of any publication issued at regular intervals not exceeding three months is exempt from the tax, except as to the newsstand sales thereof (Note: the term "newsstand sales" does not include sales of back copies of publications by the publisher or his agent)

The tax applies to purchases by publisher-printers in the same manner as custom printing. However, the manufacturing exemptions available to publisher-printers are broader in that they apply to the necessary ancillary activities of newspaper and magazine printing when such activities are performed by the publisher of any newspaper or magazine. Also, based on § 58.1-609.3(2)(v), a publisher is entitled to the industrial exemptions on equipment, printing or supplies used directly to produce a publication whether it is sold at retail or for distribution at no cost. This means that a publisher can subcontract out the printing of its publication and still receive an exemption on the printing charges.

- B. Although it is easy for taxpayers to understand that the sale of printing represents the taxable sale of tangible personal property, there are exemptions that apply to the purchase of printed materials that require some

diligence on the part of a taxpayer to interpret and organize. Under § 58.1-609.6(4) there is an exemption for catalogs, letters, brochures, reports, and similar printed materials, and the paper furnished to a printer for fabrication into such printed materials, when stored for 12 months or less in the Commonwealth and distributed for use outside of the Commonwealth. This exemption also applies to the envelopes, containers, and labels used to package and mail such printed materials. The only exception to this exemption is for "administrative supplies." The term "administrative supplies" includes, but is not limited to, letterhead, envelopes, other stationery, invoices, billing forms, payroll forms, price lists, time cards, computer cards, certificates, business cards, diplomas, and awards. The term also includes supplies for internal use by the purchaser, such as menus, calendars, datebooks, desk reminders, appointment books, employee newsletters, and other house organs.

Some "administrative supplies" may qualify for exemption if they become an integral part of the exempt printed materials described above. For example, letterhead upon which fundraising or promotional letters are printed, return envelopes enclosed with fundraising letters, and price lists enclosed within catalogs advertising tangible personal property for sale or resale are not taxable. Also, as mentioned earlier, there are some items such as menus, calendars, datebooks, appointment books, etc., that are taxable "administrative supplies" when purchased for internal use by a taxpayer. However, the same items may be exempt when used for external promotional purposes.

The key to determining whether certain printed materials are taxable or exempt is not in the product itself, but in the intended use of such product. Generally, if an item is for internal use and it is received in Virginia, it is taxable. This is true even though the item may be distributed for use outside of Virginia within 12 months (e.g. a corporate office in Virginia receives desk planners to be distributed to their employees both within and without Virginia). Conversely, if an item is for external promotional purposes and will be distributed for use outside of Virginia within 12 months, it is exempt.

Following is a list of printed materials that would qualify for exemption when stored in Virginia for 12 months or less and mailed to or distributed outside of Virginia (this list is merely illustrative and is not designed to be all inclusive):

- Fund raising and promotional letters, circulars, folders, brochures, and pamphlets, including those for charitable, political, and religious purposes;
- Corporate stockholder meeting notices;
- Proxy materials and enclosed proxy cards;
- Meeting and convention promotional materials;
- A business prospectus;
- Corporate monthly, quarterly, and annual stockholder reports;
- Announcements, invitations, and informational pieces for external promotional purposes;

- Greeting cards, brochures, menus, calendars, datebooks, desk reminders, appointment books, art prints, and posters for external promotional purposes;
 - Printed point-of-purchase sales devices, including display racks, animated and action pieces, posters and banners.
- C. Advertising businesses also have an exemption for printed materials shipped outside of Virginia within 12 months. This exemption is valid through July 1, 2012.
- D. Generally, the use of photocopy and photostat machines to make reproductions of customer furnished originals is not considered to be printing in the industrial sense. Taxpayers who operate such "quick copy" establishments must pay tax on the machinery and tools used in their business. Such taxpayers may purchase exempt from the tax only those items, such as paper, that will become ingredient or component parts of the finished products they sell. The sale of photocopies and photostats represents a taxable sale of tangible personal property.

However, per § 58.1-609.3(11), taxpayers who are engaged primarily in the printing or photocopying of products for sale or resale may purchase high speed electrostatic duplicators (or other types of high speed duplicators) exempt of the tax. A high speed duplicator is one that has a printing capacity of 4,000 impressions or more per hour (i.e. slightly more than 1 copy per second).

- E. Of particular note is the application of printing to direct mail agencies. Direct mail agencies typically use laser printing to "personalize" fund raising letters for their customers. Laser personalization consists of incorporating variable information into an existing letter copy in order to personalize the letter for each individual recipient. Based on PD 97-65 and PD 97-387, when a customer provides printing stock to a direct mail agency and the agency provides personalization services which cause each printed piece to be unique in nature, the transaction is deemed to be an exempt service. However, if the direct mail agency provides the printing stock, the transaction would be taxable.

Field Audit Procedures – Sales & Use Tax



Topic: Public Utilities

Revised: September 2016

I. References

- A. Code of Virginia:
58.1-609.3(2) (No Manufacturing Exemption for Public Service Corporations that Generate Electricity)
- B. Virginia Administrative Code:
23 VAC 10-210-3020 (Repealed 03/10/2007), 23 VAC 10-210-920
- C. Public Documents:
PD 87-276 PD 89-274 PD 89-335
PD 89-346 PD 90-68 PD 91-5
PD 91-64 PD 04-122 PD 05-56
PD 05-166 PD 06-142 PD 02-44
PD 02-44 PD 04-25 PD 04-48
PD 99-65
- D. Public Service Corporation Exemption Repeal Procedures (PD 04-122)
- E. Exemption Certificate:
ST-11, ST-11A (Pollution Control Exemption)

II. General

- A. **Effective September 1, 2004**, the retail sales and use tax exemption available to public utilities for the purchase or lease of tangible personal property used or consumed directly in the rendition of their public service was repealed. Those public utilities losing their exemption included electric suppliers, telecommunications companies, certain telephone companies, gas, water, and sewer utilities. In addition, to the extent public utilities generating electric power, qualify for the manufacturing exemption under Code of Virginia § 58.1-609.3(2), they will be prohibited from claiming the manufacturing exemption, except for raw materials that are consumed in the production of electricity, including fuel.
- B. **Transitional Rules:** The following rules are provided to clarify when purchases or leases of tangible personal property, previously exempt from the retail sales tax, are subject to the tax:
 - 1. Taxable:
 - a. Tangible personal property purchased on and after September 1, 2004.
 - b. Tangible personal property delivered to a purchaser and paid for on or after September 1, 2004, regardless of when the property was ordered.

- c. Installment sales, when the date the contract is entered into are on or after September 1, 2004
- 2. Exempt
 - a. Tangible personal property ordered, delivered and paid for prior to September 1, 2004.
 - b. Tangible personal property ordered and delivered prior to September 1, 2004 but paid for on or after September 1, 2004.
 - c. Installment sales, when the date the contract is entered into is prior to September 1, 2004, regardless of when the property is delivered or when payment is made.
- C. **Long Term Leasing Contracts:** Notwithstanding the September 1, 2004 repeal of the public utilities exemption, no sales and use tax will be imposed on the lease payments for any tangible personal property leased pursuant to a bona fide contract that was entered into before March 1, 2004, provided that such tangible personal property was delivered to or placed into service by a public utility on or before September 1, 2004.
- D. **Inventory on Hand:** Tangible personal property purchased prior to September 1, 2004, under the public utilities exemption, and placed in a tax-exempt inventory, will not lose its exempt status with the repeal of the public utilities exemption effective September 1, 2004. Such property will also maintain its exempt status upon the withdrawal from inventory and put in use in a taxable manner. It is likely this is no longer an issue as this inventory has been depleted by now.
- E. **Temporary Storage:** Effective September 1, 2004, tangible personal property brought into and stored in Virginia by a public utility, regardless of the fact the tangible personal property may be used out-of-state in an exempt capacity is subject to tax. For example, if a public utility has its central purchasing and warehousing operation in Virginia for its entire nationwide operation, all tangible personal property warehoused in Virginia is subject to the Virginia sales and use tax, unless such property qualifies for an existing Virginia exemption. Tax shall be accrued on such tangible personal property in the month the property is acquired by the public utility and brought into Virginia and remitted by the 20th day of the month following the month of acquisition or importation into Virginia.
- F. **Direct Payment Permits:** Effective September 1, 2004, all direct payment permits issued to public utilities losing their exemption were cancelled. Some utilities had their direct pay permits extended through September 30, 2005 and received permits reflecting this. Holders of direct pay permits were required to notify each of their vendors that their permits had been cancelled and future purchases were subject to the tax.
- G. **Front-End Agreements:** Any and all front-end agreements currently in force between TAX and any public utility were cancelled effective September 1, 2004.
- H. **Other Exemptions:** Other sales tax exemptions that may be available include, but are not limited to the exemption for research and development, certified pollution control equipment, resale and for tangible personal property for use

or consumption by the Commonwealth, any political subdivision of the Commonwealth, or the United States.

III. Procedures (for Audit Periods Beginning September 1, 2004)

A. Pre-Audit Steps:

1. Review previous audit:
2. Review ruling letters
3. Obtain chart of accounts
4. Review registration data for all accounts known

B. Pre-Audit conference:

1. Determine how capital and expenses are recorded
2. Obtain sales tax returns, federal returns, Form 10K, Federal Energy Regulatory Commission (FERC) Form 1.
3. Ask about associated companies, holding companies, etc.
4. Request: Chart of accounts, general ledgers, journal entries, manual checks, sales journals, list of vehicles, furniture, fixtures and equipment as well as capital jobs (construction work in process), off-road fuel reports, retired assets, and pollution control certifications.
5. FERC account numbers are not required to be used anymore and they may use SAP or another type of accounting software.
6. Questions include: What type of sales do you make? How are invoices retained and coded? How is inventory accounted for (purchases, withdrawals, adjustments)? Where are the locations and the various activities? Are there contractor relationships? Is there a laboratory? Are there R & D projects? Are there pollution control projects?
7. Request a tour of the facilities, especially at remote locations where you cannot observe the activities. This will allow you to ask pertinent questions to determine the usage as well as the unique names of the items. Each company has its own terminology.

C. Areas to review during the audit:

1. **Chart of Accounts:** Review the accounts to identify accounts that may include purchases of tangible personal property. Be careful to review what makes up the account and not go by just the name of the account. Get a detailed description or ask questions to explain what goes into the account.

It is also necessary to determine where employee sales, purchases for resale, and disposed of items are recorded.

2. **Expenses:** Due to the size of most public utilities, an ICT audit is recommended.

If the taxpayer prefers a block sample, determine the volume of records and the financial statements to use. This would follow the same procedure as a regular sales and use tax audit.

How are invoices, purchase orders retained?

If invoices are not available, the check register, a detail general ledger or purchase journal will be necessary. You also need to review the sales tax payable account for accruals and the process it flows through to the return.

3. **Stores, Materials issues or inventors withdrawals:** These are usually accounted for by a monthly report which shows the item(s), the requisitioner and the cost. An allocation of expense is recorded with a journal entry. Review the list of items withdrawn as well as the area or department to which the items are charged. Items in inventory purchased prior to September 1, 2004 are exempt when withdrawn from inventory.

Review purchases made using Purchase Cards (PCards), which are credit cards provided to select employees for certain purchases.

Review purchases made from ERS vendors (electronic reimbursement system).

4. **Raw Material and Fuel Purchases:** Raw materials and fuel that are consumed in the production of electricity are exempt. This includes fuel assemblies used in nuclear plants. Rail car leases are taxable. Both of these purchases may be included in the fuel purchases account.

- D. **Exempt General Purchases:** Items purchased for certified pollution control projects are exempt as applicable. Review the taxpayer's back-up sent to DEQ to determine what equipment was specifically certified.

R & D, as well as laboratory purchases, are exempt as the statute and regulations apply to these functions.

- E. **Turbines, Boilers, Generators, Piping Systems, Fuel Systems, Heating Systems, Cooling Systems, and Conveyor Systems:** (Real vs. Tangible Personal Property)

The determination of whether a contract is for real or tangible personal property relies heavily on the 3 criteria set out in *Danville Holding* court case. However, each contract must be looked at individually to determine if it qualifies as a real property contract or a tangible personal property contract. If the utility, itself, purchases the items that are incorporated into realty upon installation, tax must be paid to the vendor or accrued by the public utility.

In PD 06-142(12/8/06), the Tax Commissioner ruled that there is no legal basis to rely solely on federal depreciation classifications to distinguish tangible personal property from real property for local property tax purposes. Also, the Court in *Danville Holding* did not establish that the useful life of property or its accounting classification could be used to determine a party's intent to annex that property to realty. The Department may use the accounting classifications of property as a factor when determining intent, but cannot rely exclusively on this factor.

F. Sales:

Verify the sales tax reported to the sales tax payable account. Verify the accuracy of the local tax and the various locations, if applicable.

Perform a sample or detail review of sales, reviewing the invoices, transactions and documentation. Also verify the exemption certificates for those taxable sales which were not charged sales tax.

Items that may be sold to customers are generally backup generators, surge protectors, and warranty programs (either TPP or RE related). Not all utilities will sell these items.

Generally sales are a minor portion of what the utility provides. Most of their tax will be from consumer use tax.

If the utility applied for a refund of motor vehicle fuel tax from DMV for off-road fuel usage, verify the cost of the fuel has been included on the sales tax return.

There may be intercompany leases or sales which need to be reviewed. A journal entry is usually used to record this, but invoices to the associated company are also used.

Review the revenue accounts.

Co-generation companies manufacture steam or energy for other companies. Unless they are granted a certificate of convenience and necessity by the State Corporation Commission, they will at least qualify as a manufacturer if more than 50% of their product is for resale. (See P.D. 89-335)

Field Audit Procedures – Sales & Use Tax



Topic: Radio and Television Broadcasting

Revised: December 2012

I. References

- A. Code of Virginia: § 58.1-609.6(1,2,6)
- B. Virginia Administrative Code: 23 VAC 10-210-3030
- C. Virginia Tax Bulletin: VTB 95-5
- D. Public Documents:
 - PD 87-219
 - PD 88-331
 - PD 93-96
 - PD 94-51
 - PD 00-23
 - PD 01-150
 - PD 05-70
 - PD 08-167
 - PD 09-150
- E. Court Case – *WTAR Radio- TV Corporation v. Commonwealth of Virginia*
- F. Exemption Certificates: ST 20 and ST 20A

II. General

- A. Code of Virginia § 58.1-609.6 provides an exemption for:
 - 1. leasing, renting or licensing of copyright audio or video tapes, and films by licensed radio and television stations,
 - 2. broadcasting equipment and parts and accessories thereto and towers used or to be used by commercial radio and television companies,
 - 3. ending July 1, 2019
 - a. the lease, rental, license, sale, other transfer, or use of any audio or video tape, film or other audiovisual work where the transferee or user acquires or has acquired the work for the purpose of licensing, distributing, broadcasting, commercially exhibiting or reproducing the work or using or incorporating the work into another such work;
 - b. the provision of production services or fabrication in connection with the production of any portion of such audiovisual work, including, but not limited to, scriptwriting, photography, sound,

musical composition, special effects, animation, adaptation, dubbing, mixing, editing, cutting and provision of production facilities or equipment;

- c. the transfer or use of tangible personal property, including, but not limited to, scripts, musical scores, storyboards, artwork, film, tapes and other media, incident to the performance of such services or fabrication; however, audiovisual works and incidental tangible personal property described above shall be subject to tax as otherwise provided in this chapter to the extent of the value of their tangible components prior to their use in the production of any audiovisual work and prior to their enhancement by any production service;
 - d. equipment and parts and accessories thereto used or to be used in the production of such audiovisual works.
- B. Radio and television companies are exempt on purchases of equipment, parts, accessories, and towers used directly to broadcast. Broadcasting concerns must be regulated and supervised by the Federal Communications Commission.
- C. Broadcasting has been defined as disseminating a signal into the air and is considered an exempt function. Programming preparation and news gathering activities remain taxable.
- D. Broadcasting companies involved in audiovisual production are exempt on purchases of tangible personal property used in the production of audiovisual works for licensure, distribution, broadcast, etc. If audiovisual work is not used for licensure, distribution, broadcast, etc., purchases of tangible personal property are taxable.

III. Procedures

- A. **Sales:** Broadcasters may produce and sell video tapes or films. The production of the video tapes fall within two categories - media or non-media. Media tapes are exempt from sales tax. Examples of media works include: TV advertising, made-for-TV movies and programs, feature films, documentaries, radio programs, etc.

Non-media tapes include films produced for in house training, weddings, accidents, corporate meetings, product description tapes, etc. These types of films are taxable based upon the sales price of the film.

- B. **Purchases:**

1. General - A tour of the broadcasting facility with a technical engineer provides useful insight in determining the various uses of broadcast equipment. It is important to ask questions concerning the use of the equipment and accessories because some equipment may need to be prorated for use tax.

Some departments to review include weather, news, sales, graphics, control room, studio, editing, research, tape storage and administration.

Review the chart of accounts and purchases journal. The chart of accounts may be subdivided by departments, cost centers or general ledger coding. It may be necessary to review the general ledger for intercompany purchases.

2. Exempt Purchases - Broadcasting equipment used to disseminate a signal into the air is exempt. Such equipment and accessories include, but are not limited to, towers, satellite receivers, antennas, studio cameras and microphones (used for live broadcast).

Equipment, parts and accessories used or to be used in the production of exempt audiovisual works are also exempt. This includes: cameras and related equipment, computers for graphics, animation, images, lighting equipment, air conditioning/heating for use on the set, cranes and booms, dubbing, editing, and sound recording equipment.

3. Taxable Purchases - Programming, news gathering, and administration purchases are deemed to be taxable. Purchases of equipment and supplies that are not used directly to transmit a signal are also taxable. Examples include, but are not limited to, the purchase of studio furniture and lighting, news sets, interview sets, weather centers, air conditioning, heating, computers, tape carts and storage systems, weather maps, ear phones, blank tapes and reel degaussers (tape head cleaners).
4. Pro-ratable Purchases - When the same equipment and accessories are used for transmitting the signal as well as for news gathering, preparation and programming the purchases should be prorated. Examples include, but are not limited to, weather computers, routing equipment, cables, monitors, field cameras (if shooting live and taped features), tape players and recorders, audio equipment, and batteries.

Field Audit Procedures – Sales & Use Tax



Topic: Research and Development

Revised: December 2012

I. References

- A. Code of Virginia:
58.1-609.3(5)
- B. Virginia Administrative Code:
23 VAC 10-210-3070 thru 10-210-3074
- C. Public Documents:
 - PD 96-35 Direct and exclusive criteria
 - PD 96-378 Nontaxable and taxable uses
 - PD 99-8 Creating new knowledge and new understanding
 - PD 01-45 Software use, directly in research and development
 - PD 01-198 Ultimate goal for research and development exemption
 - PD 01-203 Used directly and exclusively
 - PD 02-84 Manufacturing software
 - PD 03-91 Pharmaceutical testing
 - PD 06-35 Merging multiple software
 - PD 09-136 Software modification subcontracted out
- D. Exemption Certificates:
 - ST-11(Manufacturing)
 - ST11A(Construction contractors and Non-manufacturers)

II. General

- A. **General Provisions** - Research and development must have an ultimate goal: (i) the development of new products; (ii) the improvement of existing products; or (iii) the development of new uses for existing products. Research and development does not include the modification of a product merely to meet customer specifications unless the modification is carried out under experimental or laboratory conditions in order to improve the product generally or develop a new use for the product.

Research and development does not include testing or inspection of material or products for quality control; however, in the case of an industrial manufacturer, processor, refiner or converter, testing and inspection for quality control is deemed to be an exempt activity under Title 23 VAC 10-210-920. Additionally, basic research and research and development do not include environmental analysis, testing of samples for chemical or other content, operations research, feasibility studies, efficiency surveys, management studies, consumer surveys, economic surveys, research in the social sciences, metaphysical studies, advertising, promotions, or research in connection with literary, historical, or similar projects.

- B. **Extent of the Exemption** - To qualify for the exemption, the tangible personal property leased or purchased must be “used directly and exclusively” in an

actual research process. This process should be in the “experimental or laboratory sense.” The exemption begins with the handling and storage of raw materials and supplies at the research facility and ending after the last step of the research process when the products of the research process are stored at the research facility.

Some items may be required but may not be “used directly”. When a single item is used in both an exempt and non-exempt activity, it is not deemed to be “used exclusively” in basic research or research and development activities and is taxable unless such taxable use is de minimis in nature. Proration, percentage of exempt usage or preponderance of use of an item is not permitted.

An exception to the exclusivity test is the “de minimis usage” rule. When research property is used in a taxable manner, it will only be exempt from the tax if the taxable use is de minimis in nature. Taxable use of the property is considered de minimis if the taxable usage of the property (1) does not involve a continuous or ongoing operation; (2) does not follow a consistent pattern, i.e. weekly, monthly, quarterly, etc.; (3) is occasional in nature occurring no more than three times; and (4) in total, accounts for no more than three days.

If an item, which originally qualified for the exempt status, due to its direct and exclusive use, is used in a taxable manner that is **not** considered de minimis in nature, use tax is due based on the purchase price of the item. If the conversion of the item to taxable use is six months or more after its original purchase date, the tax may be computed on the lower of the purchase price or the fair market value at the time of the taxable use.

The tangible personal property must be purchased or leased by the person, firm, corporation, or entity that actually performs the exempt research in order to qualify for the sales tax exemption. If the research equipment is purchased or leased by a party other than the person providing the research activity, the item is taxable. This is true even if the equipment is donated or loaned to an exempt entity.

- C. **Taxable and Exempt Items** – Title 23 VAC 10-210-3072 provides examples of taxable and exempt items used in basic research or research and development activities.
- D. **Contractors** - Generally, a contractor is the user and consumer of all tangible personal property furnished to or by him in connection with real property construction, reconstruction, installation, repair, and similar contracts as provided in Title 23 VAC 10-210-410. However, tangible personal property furnished to or by the contractor which will be used directly and exclusively in basic research or research and development is exempt from the tax. The contractor may purchase this property exempt of the tax by furnishing to the vendor a properly executed exemption certificate, Form ST-11A.

III. Procedures

- A. There are numerous questions and situations that auditors must review with the taxpayer to fully determine the scope of the taxpayer’s lab activity and to determine if this activity qualifies for the Research and Development or basic research exemptions.

Usually the Research and Development question applies to a manufacturer's Virginia operations. The auditor should determine if the manufacturer has other locations, and, if so, what is the nature of the research/lab activities done at the other locations. Many manufacturers have their primary Research and Development site at or near their corporate headquarters, or in a technologically advanced area such as a university research facility. Usually the lab at the production site performs testing for other reasons.

These reasons include:

1. Testing of raw materials and incoming supplies to determine if the item meets the manufacturer's specifications. This is not Research and Development but may qualify as in-process Quality Control testing.
2. Testing to determine if the customer's product can be produced with a different material (maybe less costly) and still be within the customer's contracted price.
3. Testing to determine if the product produced would work in the customer's equipment. For example, can the print cartridge be changed to work in a different model printer? The research must produce a new product or a new use for the same product. In this instance neither requirement is met. It is not a new product or new use because it is still performing the same function.
4. Testing to determine that the manufacturer's product will meet all marketing specifications. (Does not qualify as Research and Development or Quality Control testing.)

- B. The auditor must first determine why the taxpayer is conducting testing. Is it true Research and Development testing or some other type of testing?

Once the auditor verifies that the testing is Research and Development testing (see above), the auditor must review the lab procedures to determine if the equipment and supplies purchased are being used directly and exclusively for Research and Development testing and if the testing is performed in the experimental or laboratory sense as defined in Title 23 VAC 10-210-3070.

These are three very important requirements:

1. Used directly. If the item is necessary, but is not used directly in conducting the lab tests, the item is not exempt. The auditor should review each item purchased to determine if it meets this test. Furniture, storage cabinets, climate control equipment used for the comfort of the employees would be taxable, since they are not directly used in the Research and Development process.
2. Used exclusively. This is another important test. If a piece of lab equipment is used both in qualifying Research and Development research and in other non-qualifying testing, then the piece of equipment is not tax exempt since the use of that equipment was not exclusively for Research and Development unless the de minimis rule applies.

3. Experimental or laboratory sense. Testing must be conducted under controlled conditions in a laboratory environment or a place equipped for experimental study.
- C. In summary, the auditor must determine if the taxpayer conducting the Research and Development testing meets all of the Sales and Use Tax requirements to qualify for the exemption. The rules are complex and very specific. The application will vary from industry to industry and from taxpayer to taxpayer. Keep in mind that with the growth of technology and varying testing environments, the application of the Research and Development exemption may vary from audit to audit. With technological advances, new relationships may be created in the Research and Development field. These entities are partnering to provide Research and Development services to the client. In these cases, the auditor must ensure that all entities meet all Sales and Use Tax requirements to determine which part of the exemption applies, if any, to each entity.

Field Audit Procedures – Sales & Use Tax



Topic: Successor Liability

Revised: September 2016

I. References

- A. Code of Virginia:
58.1-629 (Sale of Business)
- B. Virginia Administrative Code:
23 VAC 10-210-3090 (Sale or Quitting of Business; Successor Business),
23 VAC 10-210-290 B 1 (Dealer ceasing to do business at location
indicated on Certificate of Registration)
- C. Public Documents:
PD 96-161
PD 99-297
PD 02-129
PD 07-210
- D. Court Case – *GFT Inc. vs. Commonwealth of Virginia (PD 07-210)*

II. General

A taxpayer who purchases all of the stock of an existing business may be liable for sales and use tax owed by the seller unless certain precautions are taken as provided by Code of Virginia § 58.1-629. A dealer is required to submit a final return and remit the applicable tax, penalty, and interest within 15 days of selling or quitting a business. The final return should note the name and address of the successor, if applicable.

When a business is sold, the purchaser must withhold sufficient funds to cover tax, penalty, and interest owed by the previous owner. The funds may not be released until the seller produces a receipt showing that all liability has been paid, or until the purchaser receives a certificate from the Department showing that no tax, penalty, or interest are due from the prior owner. If a purchaser fails to withhold funds, he or she may be personally liable for tax, penalty, and interest owed by the prior owner.

A certificate of registration may not be issued to a successor who has been notified by the Department that tax, penalty, and interest are due and unpaid by a prior owner until the amount is paid in full.

Virginia Code 58.1-629 applies only to sales and use tax. Furthermore, it applies only to those situations when a business is sold for a cash consideration. Successor liability may not be imposed when a business is sold for non-monetary assets such as stock or other property.

III. Procedures

- A. The policy of the Department of Taxation states that "in order to hold a successor of a business liable for unpaid sales tax under the provisions of §

58.1-629, a sale must have taken place and purchase money must have changed hands. A taxpayer taking over a business abandoned by its former owner does not fulfill the meaning of "successor" in that a sale or transfer of ownership did not take place and purchase money did not change hands. Furthermore, exchange of non-money items such as stock or land would not allow the Department to proceed against the successor".

- B. Partnerships: The liability of successor businesses depends on the facts. If a partnership adds or subtracts partners but continues without dissolving (and all creditors must be paid if the partnership goes through dissolution) it is still liable for all debts and crimes committed before the change. If the partnership is dissolved and sold to another set of partners, the new partners may agree to assume the debts of the old, in which case both the old partners and the new partnership may be liable for debts, but the new partnership has no criminal liability.
- C. Corporation: Corporations may be dissolved, merged, consolidated or sold. In any of the last three, the successor is liable for debts and subject to criminal prosecution rising from dealings of the old corporation. If the assets of a corporation are sold (rather than the stock), and the original corporation either stays in existence or is later dissolved, the liability for debts is not transferred unless there is an agreement to do so. However, it is illegal to sell all assets of a business without going through certain procedures to protect creditors.
- D. The applicability of successor liability should be evaluated as the situation arises. The auditor should evaluate the situation using the best information available to resolve the issue.

Items to consider when you suspect the successor may be liable for unpaid taxes:

- What type of business entity - individual, partnership or corporation?
 - What did purchaser buy?
 - What does the sales agreement say?
 - Was there a sale?
 - Is the successor business at the location, is the name the same, is the successor a like business?
 - Was the sale for cash or other consideration?
 - Is there a contractual agreement to purchase debts?
- E. **If there is a contractual agreement for the purchaser to be responsible for the debts of the seller, then the provision of successor in liability does not come into play.**



Field Audit Procedures – Sales & Use Tax

Topic: Service vs. Sale

Revised: December 2012

I. References

- A. Code of Virginia:
 - 58.1-609.5 (Service exemptions)
- B. Virginia Administrative Code:
 - 23 VAC 10-210-4040 (Services)
- C. Public Documents:

PD 91-185	PD 91-268	PD 92-13	PD 93-87
PD 94-120	PD 94-147	PD 94-230	PD 94-315
PD 95-5	PD 95-15	PD 95-195	PD 95-234
PD 95-252	PD 95-265	PD 95-270	PD 95-286
PD 95-300	PD 96-67	PD 98-119	PD 98-654
PD 00-129	PD 01-18	PD 04-131	PD 04-171
PD 04-199	PD 06-105	PD 08-178	PD 10-18
PD 11-74			
- D. Exemption Certificate – ST 10 (Resale)

II. General

- A. Charges for services generally are exempt from the retail sales and use tax. However, services provided in connection with sales of tangible personal property are taxable under a specific statutory exemption applies.
- B. Transactions involving both the sale of tangible personal property (“tpp”) and the provision of services, generally, are either taxable or exempt on the full amount charged, regardless of whether the charges for the service and property components are separately stated (unless a specific statutory exemption applies). The "true object" test is used to determine the taxability of these transactions
- C. Separately stated repair or installation charges are exempt from the tax but stated mileage, road service and similar service call charges are part of the taxable sales price of tangible personal property transferred to customers in repair transactions. Mileage, road service and similar service call charges are not a part of exempt installation or repair labor because these expenses are incurred prior to, in preparation of, or after the installation or repair has taken place.

III. Procedures

- A. Taxable Services Include:
 - 1. Any non-exempt services included in or in connection with the sale of tangible personal property.

2. Any non-exempt services furnished in connection with the fabrication of tangible personal property regardless of whether or not the customer furnishes, either directly or indirectly, the materials used in fabrication (see Title 23 VAC 10-210-560).
3. Any non-exempt services provided in connection with the furnishing, preparing, or serving by a person for a consideration of meals or other tangible personal property (see Title 23 VAC 10-210-930).
4. Any rooms, lodgings or accommodations furnished to transients by any hotel, motel, inn, tourist camp or cabin, camping grounds, club or any other similar place furnished for less than 90 continuous days (see Title 23 VAC 10-210-730).

B. Exempt Services Include:

1. Personal, professional, or insurance transactions which involve sales as inconsequential elements for which no separate charge is made.
2. Separately stated services performed by repairmen.
3. Separately stated labor or service charges for the repair, installation, application or remodeling of tangible personal property. However, while travel time to and from the repair service site is a charge for labor, any amounts billed for travel time, mileage or similar expenses that are incurred before or after the actual performance of repair services are not exempt.
4. Separately stated transportation charges. See Title 23 VAC 10-210-6000.
5. Separately stated charges for alterations to apparel, clothing and garments.
6. Charges for gift wrapping services performed by a nonprofit organization.
7. An amount separately charged for labor or services rendered in connection with the modification of prewritten programs.
8. Computer programs that meet the requirement of "custom programs".

- C. In order to determine whether a particular transaction which involves both the rendering of a service and the provision of tpp constitutes an exempt service or a taxable retail sale, the "true object" of the transaction must be examined. If the object of the transaction is to secure a service and the tpp which is transferred to the customer is not critical to the transaction, then the transaction may constitute an exempt service. However, if the object of the transaction is to secure the property which it produces, then the entire charge, including the charge for any services provided, is taxable.

In instances where both the services rendered and the property transferred are critical elements of a transaction, the degree of customization, uniqueness or specific services provided in connection with the product shall be considered in determining its appropriate tax status

The following are examples of transactions in which the tax status is based on these factors:

1. Taxable:
 - a) Standard data lists, reports;
 - b) Extra copies of reports, letters
 - c) Equipment rentals
 - d) Data communications equipment
2. Exempt:
 - a) Customized data lists, reports
 - b) Original letters, reports
 - c) Equipment rentals with operators
 - d) Data communications services, including equipment

Examples:

1. A taxpayer provides information retrieval services and in connection therewith leases or rents computer equipment to its customers. Charges for the retrieval service, which include charges for the lease or rental of the equipment, are exempt from the tax. However, the taxpayer is liable for the tax on the cost price of the equipment used in furnishing its services. If the taxpayer leases or sells computer equipment to customers without the provision of the information services, such lease or sale is taxable.
2. Charges for training programs which include charges for required workbooks and tapes are exempt from the tax as charges for services since the object is to obtain the training services. However, separately stated charges for workbooks and tapes are generally subject to the tax.

To assist in determining whether transactions are services or sales, the auditor should ask for or look for documents such as lease agreements, contracts, and related documents that describe the specifics of the service or sales agreement. Look for statements that include tpp as part of the agreement and other wording in the agreements that assist in defining the "true object" and indicate what the taxpayer is entitled to receive or not receive.

Field Audit Procedures – Sales & Use Tax

Topic: Schools, Colleges, Certain Educational Institutions and Other Institutions of Learning

Topic:

Revised: December 2012

I. References

- A. Code of Virginia:
 - 58.1-609.1(Government)
 - 58.1-609.10(Miscellaneous)
 - 58.1-609.11(Non-profit)
- B. Virginia Administrative Code:
 - 23 VAC 10-210-4020 (Schools and colleges)
- C. Public Documents:

PD 89-290	PD 90-35	PD 91-23	PD 91-168	PD 93-145
PD 93-241	PD 94-16	PD 94-293	PD 95-100	PD 95-255
PD 96-6	PD 96-25	PD 96-53	PD 96-98	PD 08-158
PD 10-51				
- D. Virginia Tax Bulletins:
 - 83-119, 85-10, 86-8, 92-2
- E. Exemption Certificates:
 - ST-12, Numbered exemption certificate issued by the Department

II. General

- A. Public schools and state colleges and universities – Sales to institutions of learning owned and operated by the state have the same status as other sales to the state for its use or consumption. Sales of tangible personal property to the United States, or to the Commonwealth of Virginia or its political subdivisions, are exempt from the tax if the purchases are pursuant to required official purchase orders to be paid out of public funds. Sales made without the required purchase orders and not paid for out of public funds are taxable. Sales to governmental employees for their own consumption or use in carrying out official government business are taxable.

Charges for meals, catered events, lodging and other accommodations such as meeting or conference rooms, are subject to the tax when paid for by the state or local government or public institutions of learning, or employees of such, regardless of whether the purchases are made pursuant to required official purchase orders.
- B. When conducted not for profit - Effective July 1, 2004, Code of Virginia § 58.1-609.11 allows nonprofit organizations, including nonprofit schools, that are

exempt from federal income taxation under §§ 501(c) (3) or 501(c)(4) of the Internal Revenue Code to qualify for a sales and use tax exemption. Nonprofit schools must meet certain eligibility criteria. If the nonprofit school meets the eligibility criteria, the Department will issue them an exemption letter that should be given to vendors to be able to purchase tangible personal property exempt from sales and use tax.

In addition, effective July 1, 2010, non-profit schools exempt from federal income taxation under Internal Revenue Code § 501(c) are authorized to make sales of 1) prepared food and meals and 2) tickets to events that include the provision of food, prepared food, and meals without collecting sales tax on such sales, provided certain requirements are met. Among these requirements, the school is limited to holding such events on twelve or fewer occasions per year.

- C. School Activity Funds: the tax does not apply to purchases of tangible personal property such as athletic equipment, band instruments, etc. paid for out of school activity funds if the purchases become the property of the school.

Purchases of tangible personal property paid for out of funds other than public funds or funds of the nonprofit institution of learning are subject to the tax if the tangible personal property is for the use of any school class, club, group, organization, association or individual. Such items cannot be purchased under certificates of exemption. Examples of such items are yearbooks, class rings, graduation gowns and caps, photos, school supplies, etc. for use by students.

- D. School lunches – The tax does not apply to school lunches sold and served to pupils and employees of schools and subsidized by government at any level. Equipment and supplies purchased by a school for its use in preparing and serving school lunches, and which becomes the property of the school, can be purchased under certificates of exemption.
- E. School textbooks – the tax does not apply to school textbooks sold by a local school board or its authorized agency. It also does not apply to school textbooks for use by students attending a college or other institution of learning not conducted for profit when sold (a) by such institution or (b) by any other dealer (provided such textbooks are certified by the institution as required course materials for its students). Effective July 1, 2010 this exemption was expanded to included sale of textbooks for use by students attending for-profit institutions of learning.
- F. Groups associated with nonprofit schools – Parent Teacher Association or other groups associated with an elementary or secondary school conducted not for profit must apply for and be issued nonprofit letters of exemption. The letters will indicate if they are also exempt from collecting tax on their sales.
- G. Educational institutions – Tangible personal property and services may be purchased exempt from the tax by an educational institution doing business in the Commonwealth which (a) admits regularly enrolled high school and college students, and (b) provides a face-to-face educational experience in American government, a program which (i) leads toward the successful of courses in high school in United States history, civics, and problems of democracy, or (ii) which is acceptable for full credit towards an undergraduate or graduate level

college degree, provided such institution is conducted not for profit. The property or services must be purchased by the educational institution. Individuals are not eligible for the exemption even if they are reimbursed by the institution for their expenditures. However, the exemption applies even if students, teachers or other educators participating in the institution's program use or consume the purchased property or services, including meals and lodging.

- H. When conducted for profit – the tax applies to sales of tangible personal property to schools, colleges and other institutions of learning when they are conducted for profit. They are required to pay the tax to their vendors at the time of purchase, unless their purchases are made for resale as dealers. All sales of tangible personal property made by such institutions are taxable. In addition, these institutions must collect the tax on any retail sales of meals to students or others, if the price of the meals is not included in room, board or tuition charges.

III. Procedures

Ensure that the purchases meet the wording of the certificate. Public schools and colleges are not exempt on the purchases of items such as meals and lodging. An ST-12 should be on file for entities that are owned and operated by the state and have the same status as other sales to the state for its use or consumption.

Contractors are generally subject to Virginia sales tax on the purchase of any property furnished and affixed to real estate under contracts with public school systems. However, if totally separate and distinct contracts exist for the furnishing of tangible property that will be incorporated into realty and for the installation of such property, the contractor may purchase the property exempt for resale.

The following is an exemplary list of items which are generally considered real property after installation:

- Basket racks
- Lockers
- Laboratory hoods
- Laboratory cabinets and furniture
- Benches
- Stage curtains
- Library shelves
- Cafeteria equipment

Contractors, who meet the definition of a retailer under 23 VAC 10-2 10-410(G), may sell and install the following tax exempt, even if the items become affixed to realty:

- Auditorium seats
- Basketball backboards
- Bleachers (bolted to back wall and floor)
- Chalk/bulletin boards (bolted to wall)
- Flag poles
- Folding partitions

Field Audit Procedures – Sales & Use Tax



Topic: Ship Repair

Revised: September 2016

I. References

- A. Code of Virginia:
58.1-608 3d
- B. Virginia Administrative Code:
23 VAC 10-210-4050
- C. Public Documents:
PD 85-92 (4/30/92) – vessel not engaged in plying high seas
PD 87-45 (2/26/87) – staging, spud barges, keel blocks, etc.
PD 92-140 (8/10/92)* – fuel and supplies used on dredges
PD 93-42 (3/4/93) – various items addressed
PD 93-55 (3/5/93)* – reconsideration of PD 92-140
PD 96-56 (4/23/96) – staging, scaffolding, ropes used in staging area
[*These rulings were made prior to law change adding specific exemption for dredges, fuel and supplies, etc.]
- D. Exemption Certificate:
ST-19

II. Definitions

- A. Foreign Commerce - A business venture between persons in the United States and those in a foreign country.
- B. High Seas - That portion of the ocean which is beyond the territorial jurisdiction of the United States. It does not include the Chesapeake Bay, inter-coastal waterways, or inland rivers or waterways.
- C. Inter-coastal Trade - The exchange of goods or commodities between ports.
- D. Interstate Commerce - A business venture between the people of two states.
- E. Principally - Means more than 50%.
- F. Used Directly - Those items which are both indispensable to the building, conversion, or repair process and which are used as an immediate part of such process.

III. General

- A. Shipbuilding, Conversion, and Repair -- Code of Virginia § 58.1-609.3.4 provides an exemption for:
 - 1. Ships and/or vessels used or to be used exclusively or principally in interstate or foreign commerce. Repairs and alterations to such ships and/or vessels are also exempt from the tax. Any item of tangible personal property that becomes an integral part of such ships or vessels is exempt from the tax.

2. Fuel and supplies for use or consumption aboard ships or vessels which ply the high seas either in inter-coastal trade between ports in this state and ports in other states of the United States or its territories or possessions, or in foreign commerce between Virginia ports and ports in foreign countries, when such fuel or supplies are delivered directly to such ships or vessels.

NOTE: A ship or vessel may receive the interstate or foreign commerce exemption on ship or vessel repair parts, but not receive the exemption on fuel or supplies when the ship or vessel does not ply the high seas. For example, a vessel used only for interstate commerce between Maryland and Virginia does not ply the high seas and thus is not entitled to the exemption for fuel or supplies. See PD 85-92. For other exemptions applicable to fuels, see *Va. Code* § 58.1-609.1.

3. Tangible personal property used directly to repair exempt ships or vessels. A business does not have to be exclusively engaged in ship repair in order to enjoy the exemption on tangible personal property used directly in building, converting, or repairing of such ships or vessels. On the contrary, a repair business may occasionally repair ships or vessels used in interstate or foreign commerce and still have use of the exemption.

Persons, such as shipyards, principally engaged in the building, conversion, or repair of such vessels and/or ships may also be entitled to the industrial manufacturing exemption. The manufacturing exemption includes safety apparel given to workers directly involved in the ship building, conversion, or repair process, and the storage and handling of raw materials.

An exemption is provided for those items "directly" used in the building, conversion, and repair of exempt ships or vessels. Generally consumables and purchases charged directly to a job by the repair yard are exempt from tax. However, tangible personal property costed to temporary services including, but not limited to, on-site and off-site berthing, temporary illumination, temporary electrical service, temporary phone service, and temporary sanitation service all constitute taxable areas. Items of tangible personal property used in providing such services are taxable to the shipyard.

- B. Other Waterborne Commerce (Tug Boat and Fuel Bunkering Companies) - Businesses which transverse the waterways may have a number of exemptions that apply to their operations. There is an exemption for parts which become an integral part of ships or vessels involved principally or exclusively in interstate or foreign commerce. Supplies consumed aboard a ship or vessel that plies the high seas in intercoastal trade or foreign commerce are tax exempt. Tools and supplies used directly in repairing, converting, or building such ships or vessels are also tax exempt. This exemption only applies if the vessels or ships being repaired, built, or converted are principally or exclusively involved in interstate or foreign commerce. For example, a vessel or ship which transverses the Chesapeake Bay and delivers goods or people from a location in Virginia to a location in

another state would be exempt on parts which become an integral part of such ship or vessel and would be exempt on tools and supplies used in repairing, converting, or building such ships or vessels. The business would be taxable on consumable supplies (i.e., provisions, sanitation supplies etc.) which are consumed aboard the ship or vessel since such ship or vessel does not ply the high seas. (See P.D. 93-55)

IV. Procedures

- A. Shipbuilding, Conversion, and Repair - A complete understanding of the accounting cost system is important to an audit of a shipbuilding, conversion, or repair facility. If individual tasks are not detailed in the contract, a cost account titled "temporary services" should be noted. In the latter case all items of tangible personal property costed to such an account should be taxed

The size of the facility is paramount to understanding the areas of audit concern. Large shipyards provide much more in the way of accommodation services than the smaller "down river" repair facilities. Often the smaller repair concerns act as subcontractors to the larger yards

Expense purchases, inventory withdrawals, assets, and sales should be reviewed when auditing a ship repair operation. Each area has potential tax exposure. Given the voluminous nature of inventory withdrawals, expense purchases and sales, a workable sample is required. Inventory withdrawals and expense purchases charged directly to a job may not be exempt from tax. Taxability of items can be determined by reviewing the specifics of the contract. Tangible personal property which provides for temporary services is taxable. By reviewing the specifics of the contract, many items can be deemed taxable or exempt. Normally each contract is divided into separate tasks with a detailed description. The accounting cost records are usually also quite detailed, and all expense purchases and inventory withdrawals for each job will be accounted for in the company's records. Items may be taxable even though they are costed to an exempt task. The nature of the item and its use must be understood clearly before a decision can be made on the tax status

1. Purchases and Inventory Withdrawals - Usually the taxability of items is most notable in the area of inventory withdrawals. Items withdrawn from inventory which are generally taxable when used in connection with shipbuilding, ship repair or ship conversion operations are: coffee, cups, Gatorade, padlocks (for storage of tools and supplies), trash bags, office supplies, flashlight bulbs and batteries (except when provided to workers for fire safety purposes), temporary ID tags and wire (used to identify items removed from the ship and stored while repairs are ongoing), rat guards, protective coverings, etc. See PD 93-42. The above list is not all inclusive. The items listed above can be charged to a task which is part of the repair process or a task which is not. Under either circumstance, the nature of the products and their specific use determines their taxable status. Rags are an inventory item for which the tax is prorated. Lint-free rags are normally exempt if they are charged to a repair task. This type of rag is often used to wipe turbines or dust sensitive parts of the ship or vessel. Regular

cloth rags may be used in a taxable manner to wipe part of the ship or vessel under repair or wipe tools or even workers hands. While a 50% tax proration has been used in some past audits of shipyards, a more accurate percentage may be developed on a case by case basis.

Purchases and inventory costed to overhead accounts as well as internal contracts should be carefully reviewed. As with manufacturing, items used directly in the repair, building, or conversion process are exempt from the tax to the shipyard. Items such as cranes, welding machines, tools, the mechanical dry-dock, lathes work platforms including man lifts, and work platform barges are considered indispensable to the repair, building, or conversion process, and are also exempt. See P.D. 87-45 and P.D. 96-56. Replacement parts for exempt ships or vessels are also exempt.

Supplies and tools used to work on exempt machinery and equipment are taxable. For example, the rental of man lifts and the purchase of welding gases to repair the mechanical dry-dock would be taxable. Rags and cleaners used in crane maintenance are also be taxable as are replacement parts for piers and bulkheads in that these are real property. Vehicle parts are taxable if the vehicles are for over-the-road use as compared to vehicles which transport parts to be repaired throughout the yard to various shops. The latter is similar to the movement of inventory items within a manufacturing concern

It is important to note that Title 23 VAC 10-210-920, the manufacturing and processing regulation, should aid in determining the taxability of items.

2. Sales and Services - The income areas of sales and services should be reviewed for possible tax liability. As stated earlier a review of the contracts will identify taxable tasks. There may be repair transactions involving taxable ships or vessels. In this case, tax should be charged at retail on items which become an integral part of taxable ships or vessels and on tangible personal property which sails with these ships or vessels. Fabrication labor involved in these transactions of taxable ships or vessels should also be taxed at retail. Some examples of these taxable ships or vessels are: tugs and barges owned by real estate contractors such as bridge builders, or pier and bulkhead construction companies, diving and salvage ships or vessels, yachts, and ships which leave a point in one state and return to that same point without docking in another state (dinner cruises). Consumables and supplies used directly in repairing, building, or converting the taxable ships are still exempt to the business when it is primarily involved in shipbuilding, conversion, and repair.

Items which become part of the non-exempt ship or vessel or sail with the non-exempt ship or vessel are taxable.

Ship repair facilities may also engage in some transactions which do not meet the definitions detailed in the statute. Miscellaneous sales of tangible personal property and the sale of fabricated items should be audited. Other services which provide income to the yards such as the

deactivation of a ship or vessel, which does not meet the definition of repair, building, or conversion, are taxable services and all tangible personal property consumed in providing these services are taxable.

In some ship repair and building facilities, service contracts with the government are conducted. These contracts are usually for design or testing services. These transactions fall under the federal government contract Procedures and may be subject to the government contractors regulation set out in Title 23 VAC 10-210-693.

3. Assets - Assets used directly in the building, repairing, or converting, of ships by a shipyard are exempt from the tax. The taxability of assets which are used both in a taxable and exempt manner is determined by its preponderance of use, if the ship repair facility is engaged primarily in repairing ships or vessels, *i.e.*, engaged as an industrial manufacturer. Such dual use property is most evident in the boilers that are used throughout the yard. The procedure to do a boiler function analysis and a fuel oil consumption analysis is summarized below. Maintenance chemicals which are occasionally used in a boiler to impede mineral deposit build up is taxable regardless of the taxable status of the boiler. Often larger shipyards have internal contracts which may include: the updating of facilities, the maintenance of parking lots, the relocation of certain shops, the refurbishing of dry-docks, etc. These internal jobs should be detailed and analyzed in depth. Many consumables and supplies costed to these internal jobs are taxable.

If the ship repair facility does not qualify as an industrial manufacturer because it is not primarily engaged as an industrial manufacturer, then the tax should be prorated on assets that are used both in a taxable and exempt manner.

4. Fuel Oil (when used at ship building or repair facility that qualifies as an industrial manufacturer) - Fuel oil is a major consumable supply for a ship building and/or repair facility. Diesel fuel which is used to power exempt machinery is tax exempt. Fuel oil used to operate boilers that produce steam used throughout the yard present a special problem. The steps to analyze fuel oil consumption are detailed as follows. If the analysis concludes that a particular boiler is used primarily for a taxable purpose, then the boiler and its replacement parts are taxable.

The following steps can be followed to determine the taxability of fuel oil when auditing a ship building and/or repair facility:

- a) Determine the number of gallons and the cost of fuel oil purchased, whether through actual invoices or monthly usage/cost reports, to use for the basis of calculating total taxable fuel oil.
- b) Determine the audit period and pick a representative calendar year to use as a basis for comparison.
- c) Identify the months of the year in which the average temperatures are below 55 degrees Fahrenheit. This can vary,

based on audit site location. It can be concluded that any excess over the average amount used during the other months of the year, is used strictly for heating purposes (shipboard, work buildings, and administrative buildings).

- d) Add the total amount of fuel oil purchased during the other months (those in which the temperature is above 55 degrees Fahrenheit) and divide by the number of months to calculate the average amount of fuel oil used each month for some purpose other than heating. This figure now becomes the average monthly amount of fuel oil that will be used for the entire audit period.
- e) For the "winter months" during the audit period, calculate the difference between the total amount of fuel oil purchased and the average monthly amount to determine the taxable amount of fuel oil purchased during the audit period that can be directly linked to heating. Then develop a monthly percentage in each of the winter months that is directly related to heat usage.
- f) Since the primary purpose of fuel oil usage at a ship repair facility is for the production of steam, create a comprehensive list of the various usages of steam that the fuel oil is used for and determine the taxability of each.
- g) From this list, determine a taxable percentage and an exempt percentage to apply to the monthly average amount for each month of the audit period. For the winter months, add the additional amount that was previously determined to be heat related.
- h) Applying the taxable percentage results in the total amount of taxable fuel oil used during the audit period. These monthly amounts can be either cumulative or individually broken down into percentages by taking the amount of taxable monthly fuel oil and dividing it by the total amount of fuel oil purchased during the month.

B. Other Waterborne Commerce - The previous definitions are important when auditing other waterborne industries. A complete understanding of a business's operation is necessary. Vessel/ship logs detail the voyage history. Analyze this history to determine the application of the interstate/foreign commerce exemption as well as the high seas exemption. A ship or vessel which transverses the Chesapeake Bay, intercoastal waterways, or inland rivers or waterways, but does not leave Virginia waters or otherwise does not ply the high seas, does not receive any of the exemptions detailed above. A waterborne operation must be analyzed ship by ship and vessel by vessel. A ship or vessel which transverses the Chesapeake Bay, intercoastal waterways, or inland rivers and waters, and delivers goods or people from one state to another over 50% of the time is exempt on items which become an integral part of the ship or vessel, and on tangible personal property used directly in the building, repairing, or converting of such vessels or ships. However, supplies consumed aboard such ships or vessels (*i.e.*, provisions

for the crew, cleaning supplies, and fuel to operate machinery) are taxable since these ships or vessels do not ply the high seas in inter-coastal trade or foreign commerce. Fuel used for propulsion of the ships is exempt for all ships under the marine diesel statute, *i.e.*, *Va. Code* § 58.1-609.1 6.



Field Audit Procedures – Sales & Use

Tax Topic: Sign Manufacturing and Painting

Revised: December 2012

I. References

- A. Code of Virginia:
 - 58.1-602 (Definition of tangible personal property)
 - 58.1-609.3.2 (Commercial and industrial exemptions)
 - 58.1-609.5 2 (Service exemptions)
- B. Virginia Administrative Code:
 - 23 VAC 10-210-4070* (Sign manufacturers and painting)
 - 23 VAC 10-210-920 (Manufacturing and processing).
- C. Public Documents:
 - 96-133
 - 09-51
 - 12-70
 - 12-131
- D. Exemption Certificates:
 - ST-10 (Resale)
 - ST-11 (Manufacturing)

II. General

- A. **General:** The tax applies to the charge for the manufacture or fabrication of signs, outdoor boards, and similar items. The tax applies to the total charge for the finished product including the labor involved in the construction or painting of the sign, boards, etc. Any person who constructs and installs signs, billboards or similar items which, upon installation, become incorporated into realty is considered a retailer with respect to such items. The tax does not apply to separately stated installation charges.
- B. **Sign Painting:** The tax does not apply to charges for painting signs on buildings, trucks, outdoor boards, windows, doors, etc. Materials and supplies used in performing such services are taxable at the time of purchase or withdrawal from an exempt inventory.
- C. **Neon, electric and light signs:** Any person making sales at retail, leasing or renting electric, neon or other signs must collect the tax on the total charge for such sign, excluding any separately stated installation charges.
- D. **Maintenance and Repair:** Any person making sales at retail, leasing or renting electric, neon or other signs must collect the tax on the total charge for such sign, excluding any separately stated installation charges.

III. Procedures

- A. **Purchases:** All sign manufacturers are entitled to the processing exemption set forth in Code of Virginia §58.1-609.3.2. As such, raw materials and other components which become an integral part of the fabricated signs may be purchased exempt of the sales tax. The exemption also applies to machinery, equipment and supplies used directly in the manufacturing process.

Tangible personal property used indirectly in the production process, as well as items used in administration and distribution activities are subject to the sales tax.

Machinery, equipment, and tools used in the installation of signs are subject to the sales tax. Supplies and materials used and consumed in the installation of signs are also taxable. Such items include concrete, rebar, anchor bolts, etc used for the foundation installation, and electrical wiring, cable, conduit, etc used to connect to incoming power and to ground the sign.

- B. **Sales:** The tax applies to the total charge for the finished product including labor involved in the construction or painting of the sign. The charge for replacement or repair parts is also taxable.

Installation charges are not subject to the tax provided the installation charges are separately stated.

Field Audit Procedures – Sales & Use Tax



Topic: Statute of Limitations

Revised: December 2012

I. References

- A. Code of Virginia:
 - 58.1-104 (Period of limitations)
 - 58.1-220 (Waiver of time limitation on assessment of omitted or additional state taxes)
 - 58.1-618 (Assessment based on estimate)
 - 58.1-634 (Period of limitations)
 - 58.1-1820 (Definitions)
- B. Public Documents:
 - PD 96-65
 - PD 96-179
 - PD 00-56
 - PD 07-006

II. General

- A. As provided by §58.1-634 of the Code of Virginia, the statute of limitations for the assessment of sales and use tax is generally three years from the date on which such taxes are due.
- B. The statute of limitations for the assessment of sales and use tax may be expanded to six years if a false or fraudulent return has been filed, or the taxpayer has failed to file a return and reasonable cause exists that the taxpayer was required to file a return.
- C. As provided by §58.1-220, the period for assessing taxes may be extended, if a waiver of time limitation on assessment of omitted taxes is executed on or before the expiration date of the statute of limitations by the taxpayer and the Tax Commissioner's representative.

III. Procedures

- A. As set forth in § 58.1-634, for all sales and use taxes, if no returns have been filed, the statute is six years.

For taxpayers that have been registered for less than three years, the statute may be extended to a maximum of six years if it is determined that the taxpayer was liable for the collection and/or remittance of taxes prior to registration.

If it is determined within the three year statute that the taxpayer failed to file a return for a period in which tax was due, the audit period may be extended to six years, but including only those months for which no return was filed.

- B. The fact that related corporations have filed returns does not prevent the Department from extending the statute beyond three years for an entity that has failed to file any returns.
- C. The Department is not prohibited from making an assessment of omitted taxes that were missed in a prior audit as long as the assessment is made within the statute of limitations and there exists no likelihood that a reassessment of tax has occurred.
- D. As set forth in § 58.1-220, waivers to extend the statute of limitations must be signed, by both the Tax Commissioner's representative and the taxpayer, on or before the date of expiration.

ALL waivers are to be scanned into the STAUDN work papers, and recorded in Siebel

- E. As set forth in § 58.1-618, if the taxpayer fails or refuses to execute a waiver, a statutory, or estimated assessment may be made prior to the expiration of the statute in order to protect the audit liability. The assessment amount should include all potential liability due, as no additional assessment of taxes can be made on periods outside the statute. The assessment is to be subsequently adjusted to reflect the actual liability due.
- F. Assessments are deemed to be made when written notice has been delivered to the taxpayer by an employee of the Department or mailed to the taxpayer at his last known address. The taxpayer must receive an assessment or the assessment must be postmarked on or before the statute of limitations expires for any period covered in the assessment.
- G. If an audit assessment is revised and the revision lowers the liability, the existing assessment should not be abated in full and a new assessment issued. Periods covered by the new assessment may be out of statute on the date that the new assessment is issued. Rather, the existing assessment should be abated down to the correct liability.

Field Audit Procedures – Sales & Use Tax



Topic: Telecommunication

Revised: December 2012

I. References

- A. Code of Virginia:
 - 58.1-400.1.D.2 (Minimum tax on telecommunications companies)
- B. Public Documents:
 - PD 88-75
 - PD 88-115
 - PD 89-156
 - PD 96-361
 - PD 97-225
 - PD 04-122 (Public Service Corporation Exemption Repeal Procedures)
- C. Virginia Supreme Court Case: *Commonwealth of Virginia vs. Community Motor Bus Company, Inc.*
- D. Federal Communications Commission website www.fcc.gov/wtb
- E. Exemption Certificates:
 - ST-10 (Resale)

II. General

Effective September 1, 2004, the retail sales and use tax exemption available to public service corporations, which includes telecommunication companies and certain telephone companies, for the purchase or lease of tangible personal property used or consumed directly in the rendition of their public service was repealed.

Despite the loss of the public service corporation exemption, other overlapping exemptions may be available to a public service corporation. Other sales tax exemptions that may be available include, but are not limited to the exemption for research and development, resale, and for tangible personal property for the use or consumption by the Commonwealth, any political subdivision of the Commonwealth, or the United States.

III. Procedures

- A. **Telephone Utilities:** As stated on the previous page, the retail sales and use tax exemption available to telephone utilities for the purchase or lease of tangible personal property used or consumed directly in the rendition of their public service was repealed.
- B. **Cellular Phone Companies:**

Cellular phone companies lost their retail sales and use tax exemption for the purchase or lease of tangible personal property used or consumed directly or indirectly in providing cellular phone service (e.g., antennas). Charges for

cellular phone service are non-taxable. The auditor should review purchases in the same manner as a telephone utility.

Taxability of Cellular Telephones - Cellular telephones can be provided to the customer by an authorized dealer/retailer (agent for the cellular phone service provider) in one of the following scenarios:

1. Customer pays full price for their cellular phone; or
2. Customer purchases the cellular phone for a discounted sales price beginning as low as \$.01 upon signing a service contract with the service provider for whom the retailer is an agent. The agent receives a commission/rebate from the service provider for the signed service contract; or
3. Customer receives the cellular phone at no cost from the retailer upon signing a service contract. The service provider pays their agent a commission/rebate.

In Scenario 1, tax would apply to the total sales price of the phone. In Scenario 2, the tax applies only to the discounted sales price. In Scenario 3, the retailer is required to remit use tax on the cost price of the telephone withdrawn from the resale inventory (Ref. P.D. 96-361).

B. Retailers of Telephone Equipment:

An audit of telephone equipment retailers should initially involve a review of sales transactions. This will allow the auditor to readily identify the types of equipment being sold and the applicable purchases entitled to a resale exemption.

The retailer may purchase telephone instruments and other inventory items under a resale certificate of exemption. The auditor should be aware that certain purchases charged to inventory may not be entitled to the resale exemption, such as cable affixed to real estate and similar installation materials.

Sales and purchases should be reviewed in the same manner as audits of similar retailers of tangible personal property. Exemption certificates should be reviewed to support any tax-exempt sales.

Retailers of telephone equipment were not affected by the repeal of the public service exemptions as of September 1, 2004.

- C. Digital PCS:** FCC authorization (license) to provide digital PCS is not the same as a cellular license. These are separate and distinct licenses.

IV. Transitional Rules for the Repeal of the Public Service Exemptions as of September 1, 2004. (Ref. P.D. 04-122).

The following rules are provided to clarify when purchases or leases of tangible personal property, previously exempt from the retail sales tax, are subject to the tax.

A. Taxable:

- Tangible personal property purchased on and after September 1, 2004.
- Tangible personal property delivered to a purchaser and paid for on or after September 1, 2004, regardless of when the property was ordered.
- Installment sales, when the date the contract is entered into is on or after September 1, 2004.

B. Exempt:

- Tangible personal property ordered, delivered and paid for prior to September 1, 2004.
- Tangible personal property ordered and delivered prior to September 1, 2004, but paid for on or after September 1, 2004.
- Installment sales, when the date the contract is entered into is prior to September 1, 2004, regardless of when the property is delivered or when payment is made.

C. Long-term Leasing Contracts: No sales and use tax will be imposed on the lease payments for any tangible personal property leased pursuant to a bona fide contract that was entered into on or before March 1, 2004, provided that such tangible personal property was delivered to or placed into service by a public service corporation on or before September 1, 2004. A “bona fide” contract is one that includes specific set terms and a payment schedule with a fixed duration.

D. Extension of Contracts: The extension of a bona fide leasing contract does not constitute a new contract and such equipment would remain exempt if the original contract is extended, provided the original contract was entered into on or before March 1, 2004 and the extension is executed prior to September 1, 2004. Extension of a bona fide contract after September 1, 2004 constitutes a new contract and property leased under that contract will become taxable.

E. Other Changes in the Terms of a Contract: Other changes in the terms of the contract, e.g., pricing, lease payments, finance charges, etc., will not change the exempt status of the tangible personal property provided the original contract was entered into on or before March 1, 2004 and the change to the bona fide contract is executed prior to September 1, 2004. Changes in terms occurring on or after September 1, 2004 shall be viewed as a new contract for purposes of taxation.

F. Assignment of a Contract: The assignment of a bona fide contract does not constitute a new contract provided there is no change in the terms of the contract or the original contract terms are not extended as a result of the assignment.

G. Inventory on Hand: Tangible personal property purchased prior to September 1, 2004, under the public service corporation exemption, and placed in a tax-exempt inventory, will not lose its exempt status with the repeal of the public service corporation exemption effective September 1,

2004. Such property will also maintain its exempt status upon the withdrawal from inventory and put in use in a taxable manner.

- H. **Temporary Storage:** Effective September 1, 2004, tangible personal property brought into and stored in Virginia by a public service corporation, regardless of the fact the tangible personal property may be used out-of-state in an exempt capacity is subject to the tax. For example, if a public service corporation has its central purchasing and warehousing operation in Virginia for its entire nationwide operation, all tangible personal property warehoused in Virginia would be subject to the Virginia sales and use tax, unless such property qualifies for an existing Virginia exemption. Tax shall be accrued on such tangible personal property in the month the property is acquired by the public service corporation and brought into Virginia and remitted by the 20th day of the month following the month of acquisition or importation into Virginia.

Field Audit Procedures – Sales & Use Tax



Topic: Motor Vehicle Carriers of Property

Revised: December 2012

I. References

- A. Virginia Administrative Code:
23 VAC 10-210-370 (Common carriers of property by motor vehicle -
Repealed Effective Date 03/10/2007)
- B. Public Documents:
PD 04-122
PD 12-111

II. General

Effective September 1, 2004, Code of Virginia § 58.1-609.3(3) was amended to repeal the exemption previously granted to motor vehicle common carriers. Therefore, on and after the effective date, all purchases of tangible personal property by common carriers, contract carriers and other freight transporters are taxable except under certain conditions as indicated below.

In P.D. 12-111, the Tax Commissioner determined that the airline exemption extended to highway vehicles used to transport revenue generating customer cargo and packages destined for air transport by the airline. Thus, airline exemption was determined to apply to vehicle maintenance parts used to repair revenue-generating trucks and vans (used for pick up and/or delivery of customer cargo or packages) that are part of the Taxpayer's integrated transportation system that uses both air and ground transportation to carry out its public services.

Generally, sales in interstate or foreign commerce are exempt from the tax pursuant to the exemption set out in *Va. Code* § 58.1-609.10 4 for "[d]elivery of tangible personal property outside the Commonwealth for use or consumption outside of the Commonwealth."

Title 23 VAC 10-210-780 provides four examples of exempt sales in interstate commerce. One example provides an exemption when the delivery is made by the seller to a common carrier or the U. S. Post Office for delivery outside the state. With the elimination of Title 23 VAC 10-210-370, the Department must look to the common definition of the term "common carrier" to determine whether a carrier would satisfy the interstate sale exemption.

In Public Document (P.D.) 11-6 (1/14/11), the Tax Commissioner cited the common definition of the term "common carrier" from *Black's Law Dictionary*, 5th Ed., page 249 (1979), as follows:

Any carrier required by law to convey passengers or freight without refusal if the approved fare or charge is paid in contrast to private or contract carrier. One who holds himself out to the public as engaged in business of transportation of persons or property from place to place for

compensation, and who offers services to the public generally. *Tilson v. Ford Motor Co.*, D.C.Mich., 130 F. Supp. 676, 678. Such is to be distinguished from a contract or private carrier.

In contrast and as set out in P.D. 11-6, *Black's Law Dictionary* 5th Ed., page 294 (1979), defines the term "contract carrier" as follows:

A carrier which furnishes transportation service to meet the special needs of shippers who cannot be adequately served by common carriers. *Samardick of Grand Island-Hastings, Inc. v. B. D. C. Corp.*, 183 Neb. 229, 159 N.W.2d 310, 315. A transportation company that carries, for pay, the goods of certain customers only as contrasted to a common carrier that carries the goods of the public in general.

It has been the longstanding policy of the Department that tangible personal property delivered out-of-state by a contract carrier hired by the purchaser is not considered a sale in interstate commerce when the purchaser exercises a right or power over the tangible personal property incident to ownership while the property is in Virginia. See P.D. 89-87 (3/8/89) and P.D. 93-86 (3/29/93). Notwithstanding such policy, the Tax Commissioner has issued rulings regarding the characteristics of contract carriage. For instance, in P.D. 96-347 (11/25/96), the Tax Commissioner noted that contract carriage involved a written agreement for the provision of transportation and identified the parties to the agreement, contained the contract rate, committed the carrier to transport a series of shipments, and stated that the carrier provides services designed to meet the distinct needs of the shipper. Also, in P.D. 96-347, the Tax Commissioner agreed to follow the intent of the Interstate Commerce Commission's Negotiated Rates Policy which allowed a common carrier to negotiate rates with its customers. Furthermore, the Tax Commissioner accepted the premise that written agreements between a carrier and its customer which merely set a negotiated rate are not necessarily indicative of contract carriage.

Field Audit Procedures – Sales & Use Tax



Topic: Vending Machine Sales

Revised: December 2012

I. References

- A. Code of Virginia:
58.1-614
- B. Virginia Administrative Code:
23 VAC 10-210-6040 through 6043
- C. Virginia Tax Bulletin:
VTB 82-6
- D. Public Documents:
 - PD 08-112 Vending machine sales
 - PD 04-121 Vending machine sales tax rate increase Procedures
 - PD 97-218 Computation of tax, alternative method
 - PD 97-302 Honor box type sales
 - PD 89-300 Adjustments to cost of goods sold/shortage allowance
 - PD 89-286 Lease of vending machines
 - PD 87-199 Alternative reporting method approved
 - PD 86-122 Coin operated amusement games
- E. Exemption Certificate:
ST-10

II. General

- A. The Virginia Administrative Code places those who sell tangible personal property through vending machines into three separate categories. Each category calculates the tax differently and has a separate code number.
 - 1. **Regulation 23 VAC 10-210-6041** - *dealers in the business of placing vending machines and selling tangible personal property through those machines.*

Tax computed on Cost of Goods Sold – Form VM-2

These dealers file **form VM-2** monthly and calculate tax due based on the purchase price of the goods sold in the machines for that month. Dealers who manufacture the tangible personal property to be sold shall compute the tax on the cost of goods manufactured (raw materials, labor and overhead) for those items sold. **The tax rate for vending machine sales is 1% more than the regular state sales tax rate, plus 1% tax for each locality in which the machines are located.**

The regulation allows for an alternative method of computing tax if the dealer is unable to maintain adequate records to determine cost of goods sold. With permission from the Tax Commissioner, the dealer

may compute tax using the regular sales tax rate, on gross receipts for the month. Form ST-9 is used to file on gross receipts.

2. **Regulation 23 VAC 10-210-6042** – *dealers under contract with nonprofit organizations*

Tax computed on adjusted gross receipts less sales under \$.10 – Form ST-9

Dealers engaged in the business of placing vending machines, **all of which are under contract to nonprofit organizations**, may deduct sales of \$.10 or less from gross receipts and divide the remaining balance by one plus the sales tax rate (current 2012 1.05%) to determine the amount of taxable sales upon which the **regular sales tax rate** is applied. These dealers report on Form ST-9.

3. **Regulation 23 VAC 10-210-6043** – *other dealers selling tangible personal property through vending machines.*

Tax computed on total taxable sales – Form ST-9.

Dealers not engaged in the business of placing vending machines but who use vending machines at their places of business to sell merchandise, e.g., service station operators etc., must report the tax at the regular ST rate on gross taxable sales on the same return, ST-9, on which nonvending machine sales are reported.

B. Purchases by Dealers:

Items to be sold in the vending machines may be purchased tax exempt using exemption certificate ST-10. Dealers who manufacture or process tangible personal property for sales may be entitled to the industrial exemption for tangible personal property.

All tangible personal property purchased for use or consumption by the dealer and not for resale, including vending machines and repair parts for such machines, and withdrawals of tangible personal property from a tax exempt manufacturing or resale inventory for use or consumption by the dealer are subject to the tax at the regular sales tax rate on the purchase price of the property.

III. Procedures

- A. The first step in conducting an audit of a vending machine dealer is to determine under which regulation they fall and which method is being used in reporting the tax. A pre-audit conference is helpful in gaining knowledge of the dealer's overall operation. Also, the auditor should become familiar with Form VM-2 and review the instructions.
- B. The vending machine return VM-2 does not provide for the taxation of sales made outside of vending machines. Nor does it provide for the accrual of tax on items used by the dealer, such as machines and machine parts, office supplies, etc.

When auditing a dealer who places vending machines, the auditor should check to see if they make retail sales outside of the vending machines. Examples of this would be bulk sales of coffee or soft drinks to businesses to

provide to employees. Dealers also will sell older vending machines to other dealers. If the dealer is making these types of sales, they also need to be registered for Retail Sales Tax and file an ST-9 in order to tax the bulk sales and machine sales at the regular sales tax rate.

If the dealer is not making retail sales outside of vending machines but needs to make tax accruals on purchases for their own use at the regular sales tax rate, the dealer will have to be registered for Consumer Use Tax in order to make the necessary accruals

- C. The auditor should review the methodology being used to compute the tax due.
- Verify monthly gross receipts from vending machines
 - Verify that the 23 VAC 10-210-6042 dealer is computing taxable gross receipts correctly.
 - Verify the accuracy of how the 23 VAC 10-210-6041 dealer is computing COGS. (One method is to take the monthly gross receipts from each segment –drinks, snacks, other—and reduce that total by the markup percentage to determine the approximate cost price). Verify that the dealer is not making any unauthorized adjustments to COGS.
 - Instead of using COGS, a dealer remitting tax based on 23 VAC 10-210-6041 may be taking the total purchases for the month and calculating tax on that amount. The rationale for this is it's simpler, and that all the purchases will eventually be sold. Reasonable adjustments are allowed for spoilage, breakage and loss.
 - If the 23 VAC 10-210-6041 dealer is a non-filer for multiple periods, the easiest auditing method is to apply tax to total monthly purchases with allowable adjustments.
 - Verify that the allocation for localities is correct. Tax is due to localities where vending machines are located, and some dealers have machines in several localities.
- D. The auditor should also be aware that there are usually withdrawals from inventory for the dealer's own use, and a percentage for this needs to be determined. Withdrawals from inventory are taxed at the regular sales tax rate.
- E. For dealers who fall under 23 VAC 10-2106043, including gas stations, grocery stores, drug stores, etc., a review should be made to verify that the vending machine sales are being included with the other sales on the dealer's ST-9.
- F. Purchases or leases of vending machines and repair parts are taxable and considered tangible personal property consumed by the dealer and not for resale. These are subject to the use tax at the regular sales tax rate. A careful review of this area should be completed to assure that compliance is being met.

- G. When using STAUDN for Vending Machine registration audits, select *Sales Tax* as the type of audit under taxpayer information. Under the Audit Setup, a measure called something like *VM Purchases* can be created and the tax rate set at 1% Local and State at one percent above regular sales tax rate (current 2012 amounts 5% State and 1% Local). A measure such as *Withdrawals from Inventory* can also be created, if this is found, and the tax rate set at the regular sales tax rate.

Any non vending sales, plus asset and personal use purchases, are computed in another STAUDN file, using the dealer's Retail Sales tax registration with all measures at the regular sales tax rate. If there are no non vending sales, only asset and personal use purchases, an audit report for the Consumer Use tax registration is created, computing tax at the regular sales tax rate.

Field Audit Procedures – Sales & Use Tax



Topic: Veterinarians

Revised: December 2012

I. References

- A. Code of Virginia:
 - 58.1-609.10 (9)
 - 58.1-609.2 (1)
- B. Virginia Administrative Code:
 - 23 VAC 10-210-6050 (no longer correct)
- C. Public Document:
 - PD 10-210
- D. Virginia Tax Bulletins:
 - VTB 86-4
 - VTB 87-9
- E. Exemption Certificates:
 - ST-18 (purchases of medicines and drugs) and ST-10 (resale)

II. General

Veterinarians are generally deemed to be the taxable users or consumers of all tangible personal property used in their practices. However, effective July 1, 2006, §§ 58.1-609.2 and 58.1-609.10 of the Code of Virginia were amended to provide an exemption from the sales and use tax for medicines and drugs sold to or purchased by a veterinarian, provided that those items are used or consumed directly in the care and treatment of agricultural production animals. An exemption is also available to veterinarians for medicines and drugs purchased for resale to a farmer for direct use in producing an agricultural product for market.

This exemption applies only to medicines and drugs used for the treatment of “agricultural production animals,” and does not apply to those items used to treat domesticated animals such as dogs and cats, and recreational animals, such as horses used for recreational purposes. Veterinarians should pay tax on those medicines and drugs.

The sale of soaps, flea powders, leashes, collars, pet foods, and similar products are taxable. Veterinarians may purchase such items exempt of the tax using certificate of exemption ST-10. Veterinarians are required to collect and remit the tax to the Department on the full retail amount of the tangible personal property sold, whether or not such sale is in conjunction with an office visit or examination. Veterinarians are required to accrue the tax on any items removed from a resale inventory for use and consumption in boarding services.

III. Definitions

Agricultural animals – all livestock and poultry §3.1-796.66.

Livestock – includes all domestic or domesticates: bovine (cows) animals; equine (horses) animals; ovine (sheep) animals; porcine (swine) animals; cervidae (deer) animals; capradae (antelope) animals; animals of the genus lama; ratites (ostriches, emus); fish or shellfish in aquaculture facilities, as defined in §3.1-73.6; enclosed domesticated rabbits or hares raised for human food or fiber; or any other individual animal specifically raised for food or fiber, except companion animals §3.1-796.66 (parenthetical information added).

Poultry – includes all domestic fowl and game birds raised in captivity §3.1-796.66.

Controlled drugs – drugs that are kept under lock and key such as narcotics and/or amphetamines.

Prescribed medicines – products that can only be dispensed on the written prescription of a licensed veterinarian.

Prescription diets - pet food that is prescribed to treat a specific medical condition.

Supply items-sutures, splints, bandages, office supplies, etc.

Other resale products - soaps, powders, vitamins, leashes, collars, and products that may be labeled “only available through veterinarians” but are resale items, and regular pet food.

IV. Procedures

The tax does not apply to the purchase or use of medicines and drugs to treat “agricultural production animals.” Agricultural animals are those animals defined above as either livestock or poultry. Purchases of the same medicines and drugs are taxable to veterinarians when used to treat domesticated animals such as dogs and cats, and recreational animals, such as horses used for recreational purposes. Veterinarians must accrue and remit the tax on any such medicines or drugs purchased exempt of the tax and later used to treat non-exempt animals.

Prescription diets used in the treatment of animals and prescription treatments for flea control and animal skin conditions are considered controlled drugs or prescribed medicines.

Purchases of all equipment and supplies used in a veterinarian’s practice are subject to sales tax.

Purchases of lost pet recovery products such as microchips and scanners are taxable to veterinarians. Veterinarians are providing a non-taxable service when they implant the microchips.

Veterinarians, who keep an inventory of resale items such as soaps, flea treatments, etc, must register and collect sales tax on their retail sales. These items are treated as retail items regardless of whether the sale of such items is in conjunction with an office visit or examination.

A special note may be made regarding horses. Horses (equine animals) fall under the definition of livestock. However, the law specifically taxes medicines and drugs (in addition to feed and supplies) for the treatment of recreational animals. This leads to the following delineation:

Exempt:

- Breeding horse (on a breeding farm) so long as the horse has not entered showing, at which time the exemption ceases.
- Plow or draft horse used in agricultural production.
- Permanently Retired Racing Horses PD 94-174

Taxable – Recreational Horses

- Horse being shown PD 04-162
- Buggy Horse
- Pet horse
- Riding horse PD 07-043
- Racing horse PD 91-294
- Pet or hobby horse that has been bred

Field Audit Procedures – Sales & Use Tax



Topic: Watercraft Tax vs. Sales Tax

Revised: December 2012

I. References

- A. Code of Virginia:
 - 58.1-609.1(6) (Retail tax exemption for motor fuels, diesel fuel, and clean special fuels for use in a boat or ship, upon which a fuel tax is refunded.)
 - 58.1-609.1(9) (Exempts watercraft as defined in § 58.1-1401 from the retail tax.)
 - 58.1-609.2(4) (Commercial waterman exemption from the retail tax.)
 - 58.1-609.3(4) (Retail tax exemption for ships and vessels used or to be used principally in interstate or foreign commerce.)
 - 58.1-1400 thru 58.1-1410 (Virginia Watercraft Sales and Use Tax)
- B. Virginia Administrative Code:
 - 23 VAC 10-210-351 (Commercial waterman)
 - 23 VAC 10-210-4050 (Ships and vessels used or to be used principally in inter-state or foreign commerce)
 - 23 VAC 10-210-6060 (Watercraft sales, leases, and rentals; repair and replacement parts, and maintenance materials)
 - 23 VAC 10-230-10 thru 23 VAC 10-230-130** (Virginia Watercraft Sales and Use Tax Regulations)

** Sections 23 VAC 10-230-10, 50, 60, 70, 100 and 130 were repealed in 2007. The Watercraft Sales and Use Tax regulations were amended effective March 8, 2009 (Virginia Register Volume 25, Issue 8)

- C. Public Documents:
 - PD 07-26 Dyed diesel fuel for use in operating pleasure watercraft is subject to the retail sales and use tax
 - PD 00-196 Undocumented vessels sold in Virginia
 - PD 98-93 Foreign registered yacht exempt
 - PD 95-279 Nonprofit organizations, exempt status
 - PD 95-75 Barge has no motor so it is not a watercraft-retail tax applies.
 - PD 93-155 Rentals of watercraft are taxed at 2%. Rentals of canoes and kayaks are taxed at 5%.
 - PD 90-213 Fishing vessels used by commercial watermen are exempt from the retail tax, but only watercraft constructed by a commercial waterman for his own use are specifically excluded from the watercraft tax.
 - PD 88-176 Sales of interval ownership interests in watercraft are not subject to either tax, however the watercraft tax is due on the initial purchase of the watercraft.
 - PD 86-151 An association which chartered and maintained vessels for their owners and received a monthly fee as well as a

percentage of the charter was not considered a watercraft dealer.

- D. Virginia Tax Bulletins:
 - VTB 10-9 The Retail Sales and Use Tax Treatment of Certain Fuels.
 - VTB 97-5 Definition of Watercraft and Watercraft Dealer
 - VTB 94-9 Application of the Watercraft Sales and Use Tax to the Sale of Boat Motors
- E. Legislative Summaries:
 - 2011 Legislative Summary – Commercial Watercraft Fuel Exemption Expanded
 - 1997 Legislative Summary – Definition of Watercraft - Expanded, Amended and Clarified
- F. Exemption Certificates:
 - ST-10 (Resale)
 - ST-16 (Waterman)

II. General

- A. **Watercraft Tax is Imposed on the Purchaser** - A 2% watercraft tax is imposed upon the purchaser of any watercraft sold in Virginia and upon the user of any watercraft not sold in Virginia, if required to be titled with the Department of Game and Inland Fisheries for use in Virginia.
- B. **General Description of a Watercraft Subject to the Watercraft Tax** - A watercraft means any motor-powered boat, or any sail-powered boat in excess of 18 feet in length, but not boats that have valid marine titling documents issued by the U.S. Coast Guard. Any motor purchased separately to be used to power a watercraft is also subject to the watercraft tax. A vessel need only be propelled by machinery. This machinery does not have to be the principal source of propulsion.
- C. **Watercraft Tax vs. Retail Tax** - All transactions subject to watercraft tax are exempt from the retail tax; however, all watercraft not subject to the watercraft tax are subject to the retail tax. It is the intent of the sales and use tax laws to tax all marine vessels (unless otherwise exempt) according to one or the other tax rate (2% or 5.0%) but not both.
- D. **Watercraft Dealers** –Watercraft dealers are exempt from both the retail and watercraft taxes on purchases of watercraft for resale and also on purchases of watercraft for lease, charter or other use for compensation, but are subject to the watercraft tax on the gross receipts from lease, charter or other use. Gross receipts tax on the lease, charter or rental of watercraft is not separately stated.

III. Watercraft Tax Definitions

- A. **“Dealer”** means "any watercraft dealer as defined in Code of Virginia § 29.1-801 (the Watercraft Dealer Licensing Act)." This definition includes any person who sells or offers to sell two or more watercraft within any twelve consecutive months.

The regulation definition of dealer is more general and adds that "the Commissioner may find such person to be a dealer." For the most part, a

watercraft dealer is governed by the laws pertaining to the Department of Game and Inland Fisheries (DGIF). The decision to register with DGIF as a watercraft dealer is generally not voluntary. That is, if a person meets the definition of a "watercraft dealer", that person must register with DGIF.

However, a watercraft dealer is not required to register with the Department of Taxation to collect and remit the Watercraft Sales and Use Tax on the sale of watercraft. Such registration (and the collection and remittance of the Watercraft Sales and Use Tax) is voluntary. If a watercraft dealer elects not to collect the Watercraft Sales and Use Tax, the tax is imposed on the purchaser.

- B. **"Gross receipts"** means "the amount received for the lease, charter, or other use of any watercraft. The term shall include hourly rental, maintenance, and all other charges for use of any watercraft and charges for pilots, crew, or other services, unless separately stated on the invoice. The term shall also include the amount by which the price estimated under § 58.1-1403 exceeds the charge actually made.
- C. **"Sale"** means "any transfer of ownership or possession of a watercraft by exchange or barter, conditional or otherwise, in any manner. The term shall also include (i) a transaction whereby possession is transferred but title is retained by the seller as security, (ii) any lease or rental for a period of time substantially equal to the remaining life of the watercraft, and (iii) any lease or rental requiring total payments by the lessee during the lease or rental period which substantially equals the value of the watercraft. The term shall not include a transfer of ownership or possession made to secure the payment of an obligation." The regulation definition goes into detail about determining the remaining life and valuation of watercraft. It defines "substantially equal" to mean 80% or more. The regulation states that "[t]he same sale will not be subject to the tax more than once. However, unless it is an exempt transfer, each time a transfer of ownership or possession takes place, the new owner will be subject to the tax on the transfer." In addition, the regulation (23VAC10-230-40), cites seven types of transfers that the term sale does not include and provides two examples. Finally the regulation excludes from the term "sale" the "[t]ransfer of watercraft repair parts, accessories, attachments, and lubricants, not included in the same transaction with the transfer of the watercraft." Sales of all such tangible personal property (TPP), except motors to power watercraft, are subject to the retail tax.
- D. **"Sale price"** means "the total price paid for a watercraft and all attachments thereon and accessories thereto, exclusive of any federal manufacturer's excise tax, without any allowance or deduction for trade-ins or unpaid liens or encumbrances." The regulation definition of sale price includes additional information. "The terms 'attachments thereon' and 'accessories thereto' as used herein mean all [TPP] that is physically attached to watercraft, including installation charges, or property that is customarily used in watercraft, whether or not affixed to the structure of the watercraft, and which was transferred in the same transaction as the watercraft as a part of the watercraft sale. Such [tpp] transferred other than in the same transaction with the watercraft will be subject to the ..." retail tax. In addition, [c]harges for lettering and get-ready charges (cleaning, washing and preparing) are also

included in the sale price when made in the same transaction with the watercraft transfer. However, excluded from the sale price are charges for federal manufacturer's excise tax, registration and titling fees, insurance, and gasoline, when separately stated on the invoice." Note that the base for computing the watercraft tax excludes manufacturer's excise taxes, but not retailer's excise taxes. Thus any federal "luxury tax" on a watercraft is included in the base for computing the watercraft tax since it is classified as a retailer's tax.

- E. **"Watercraft"** means any vessel propelled by machinery whether or not the machinery is the principal source of propulsion. The term shall also include any sail-powered vessel, which is in excess of eighteen feet in length measured along the centerline. The term shall not include a seaplane on the water or a watercraft which has a valid marine titling document issued by the United States Coast Guard."

The first paragraph of the regulation definition contains the superseded definition of "watercraft" and should be ignored; however, the second and third paragraphs contain information about documented vessels. Code of Virginia § 58.1-1401.1, in effect, adds to the definition of watercraft and is entitled "When motor deemed a watercraft." It became effective on 7/1/94 and states that "[a]ny motor used to power a watercraft as defined in § 58.1-1401 and sold separately from such watercraft shall be deemed a watercraft for purposes of this chapter."

- F. **"Person"** as defined by the regulation "[m]eans every natural person, firm, partnership, association, corporation, or other entity."

IV. Procedures

- A. Application of the Watercraft Tax to the Sale of Boat Motors - Virginia Tax Bulletin 94-9 deals with the 1994 statute in which any motor that powers a watercraft and sold separately from the watercraft, is itself deemed a watercraft. A registered watercraft dealer will only collect the 2% watercraft tax on such a motor. A retail dealer still collects the 5.0% tax but the customer who purchased the motor for a watercraft can obtain a partial refund from the Department of Taxation by submitting a refund request to: Department of Taxation, Office of Customer Services, PO Box 1115, Richmond, Virginia 23218-1115. The request must include a copy of the invoice for the motor with the amount of sales tax charged separately stated.
- B. **Watercraft Tax Levied** - Code of Virginia § 58.1-1402 describes how the amount of tax to be collected is determined:
1. 2% of the sale price of each watercraft sold in Virginia.
 2. 2% of the sale price of each watercraft not sold in Virginia but required to be titled in Virginia. However, if the watercraft is first required to be titled in Virginia six months or more after its acquisition, the tax shall be 2% of the market value of such watercraft at the time it is titled.
 3. 2% of the gross receipts from the lease, charter or other use of any watercraft by a registered dealer. Note: effective January 1, 1998 watercraft includes small motorboats and jet skis.

This code section also contains the \$2,000 maximum tax limitation. The regulation corresponding to the statute states that the current market value includes "the cost of any modifications, improvements or additions subsequent to initial acquisition." The regulation has paragraphs titled "Each Transaction Taxable," "Requirement to be Titled," and "Current Market Value." The regulation also contains a paragraph titled "Occasional Sale" which states that the watercraft tax applies to an occasional sale. "Occasional sale means a sale of a watercraft by anyone not a dealer in watercraft."

C. **Watercraft Tax Exemptions** - Code of Virginia § 58.1-1404

1. Sales to federal, state and local governments and sales to insurance companies for the sole purpose of settling a claim.
2. Any person who was the owner of a watercraft which was not required to be titled prior to 1/1/98 can apply for a title without incurring the watercraft tax.
3. Any watercraft constructed by a commercial waterman for his own use. (Note: The exemption, as it pertains to commercial watermen, is only applicable when the actual vessel is constructed by the waterman for his own use. There is no exemption from the watercraft tax for watercraft purchased by or constructed by a boat yard on behalf of a commercial waterman.)
4. Any registered dealer in watercraft is exempt from the tax imposed in paragraphs 1 and 2 of § 58.1-1402. A registered dealer is also exempt from the titling requirement in § 29.1-713.
5. Any watercraft purchased by and for the use of a volunteer sea rescue squad, volunteer fire department or a volunteer rescue squad. (All are required to be nonprofit.)
6. Any watercraft transferred to trustees of a revocable inter vivos trust, when the owners of the watercraft and the beneficiaries of the trust are the same persons, regardless of whether other beneficiaries may also be named in the trust instrument, or transferred by trustees of such a trust to beneficiaries of the trust following the death of the grantor, when no consideration has passed between the grantor and the beneficiaries in either case, shall be exempt from the tax imposed under this chapter.

The following statement is found at the end of the exemption regulation:

"Note: The exemptions of this section do not apply with respect to rentals, leases or charters in the case of a dealer who pays a gross receipts tax under the dealer exclusion, as the gross receipts tax is levied on the dealer and not upon the renter, lessee, or other user."

- D. **"Dealers' Certificates of Registration"** - Code of Virginia § 58.1-1406 - Paragraph A of the statute states that "[e]very person who qualifies as a dealer ... and desires to transfer ownership without obtaining a certificate of title, shall file with the Tax Commissioner an application for a certificate of registration for each place of business in the Commonwealth." This statute implies the voluntary nature of a dealer's decision to register for the watercraft

tax. Once registered, however, the watercraft dealer must act in strict compliance with all of the statutes, especially concerning leasing or renting of watercraft. Because a watercraft dealer is subject to tax on his gross receipts, the watercraft tax is imposed on the dealer instead of the renter or lessee. Therefore, the exemptions found in Code of Virginia § 58.1-1404 are not applicable. For example, gross receipts from rentals, leases or charters to the federal, state or local governments must be included in the dealer's gross receipts and are subject to the watercraft tax. Most active dealers of watercraft agree to register for watercraft tax because as paragraph E states: "Only those dealers who hold a current certificate of registration hereunder shall be authorized to transfer ownership of a watercraft without obtaining a certificate of title therein, and paying the tax imposed by this chapter." The dealer exclusion regulation contains useful information regarding watercraft dealers not found in the statutes and is generally accurate. A watercraft dealer may purchase watercraft for subsequent lease, rental or sale exempt of the tax. Also, paragraph C of 23 VAC 10-210-6060 states that "[r]epair and replacement parts and accessories installed on a watercraft at the time of sale, or on leased or rented watercraft, that are included in the sales price for computing the [watercraft tax] or in gross receipts from a lease or rental are exempt from the [retail tax]. Such items may be purchased by a dealer, as defined in § 58.1-1401 of the Code of Virginia and the accompanying regulations, exclusive of the [retail tax] when a resale exemption certificate, Form ST-10, is presented at the time of sale. Repair parts purchased by non-dealers for installation on watercraft are not exempted from the retail tax."

- E. **Coast Guard Documented Vessels** - The statute specifically exempts from the watercraft definition any watercraft which has a valid marine document issued by the United States Coast Guard. The regulation definition discusses this topic in more detail. "Marine documentation is issued by the United States Coast Guard to the owner(s) of vessels or watercraft as evidence of ownership in such vessels or watercraft. Valid documentation becomes void upon sale and must be reinstated in the name(s) of the purchaser(s). Therefore, for purposes of this chapter, no watercraft will be considered to have a valid marine document when purchased ..." in Virginia. Conversely, vessels which are purchased and documented outside Virginia, but brought into this state for use with valid documentation are exempt from the 2% watercraft tax, but subject to the 5.0% retail tax. However, Virginia will give credit for valid sales type taxes paid to another state. (Refer to Code of Virginia § 58.1-1409.) Note that there is no maximum tax limitation for the retail tax.
- F. **Commercial Watermen are Usually Liable for Watercraft Tax** - A commercial waterman enjoys an extensive (but not complete) exemption from the retail tax. 23 VAC 10-210-351 was broadened in 1994. Items such as boats, boat motors, parts, machinery, tools, equipment, etc. are exempt from the retail tax when purchased by a commercial waterman who can present a valid ST-16. There is a provision for proration of the retail tax if a commercial waterman's use of an item is not entirely exempt. There is no exemption from watercraft tax for commercial waterman except when a commercial waterman actually constructs a watercraft for his own use. Any machine-powered vessel (regardless of length or amount of horsepower) is defined as a

watercraft. Accordingly, a purchase of any powered boat by a commercial waterman is subject to the 2% watercraft tax. A commercial waterman also pays the watercraft tax on a motor that powers a watercraft.

- G. **Watercraft Records** - Code of Virginia § 58.1-1403 requires every watercraft buyer be provided with an invoice signed by the seller or his representative, which states the sales price. Paragraph C of this section sets out the department's remedies when an invoice does not exist or a misrepresentation occurs. Code of Virginia § 58.1-1407 requires that any invoice(s) be kept by the seller for three years following the sale.
- H. **Ships or Vessels Used or to be Used Exclusively or Principally in Interstate or Foreign Commerce are Exempt from the Retail Tax** - Such vessels are exempt by Code of Virginia § 58.1-609.3(4) from the retail tax. They are described in 23 VAC 10-210-4050. These vessels are usually exempt from the watercraft tax because they have valid Coast Guard documentation or are not required to be titled in Virginia. (Refer to the regulation)
- I. **Retail Tax Exemption for Boat or Ship Fuels** - Code of Virginia § 58.1-609.1(6) exempts "[m]otor fuels, diesel fuel, and clean special fuels for use in a commercial boat or ship, upon which a fuel tax is refunded ..." Dyed diesel fuel and other fuel that is not used in a highway vehicle is exempt from the Virginia fuels tax (i.e. recreational and pleasure watercraft), and thus is subject to the retail sales tax.

Effective July 1, 2011, the definition of "commercial watercraft" for the purposes of the Retail Sales and Use Tax exemption for fuels used in a commercial watercraft was expanded to include watercraft owned by a private business and used in the conduct of its own business or operations, including but not limited to the transport of persons or property.

Field Audit Procedures – Sales & Use Tax



Topic: Audit Selection

Revised: September 2016

I. General

The auditor is to conduct field audits of the taxes administered by the Department in order to determine taxpayer compliance. The ultimate goal is to have total compliance with the tax laws. Taxpayers selected for audit are those deemed to be in non-compliance. It is the auditor's job to identify those taxpayers most in need of audit.

II. Procedures

- A. There are two steps prior to the selection of audit candidates:
 - 1. Identification
 - 2. Research
- B. Identification - There are several sources used to identify audit candidates.
 - 1. Audit recommendations - These taxpayers have been identified by other auditors or other employees who have evidence of activity in Virginia or some of type of taxpayer error.
 - 2. Recurring audits - Based upon the results of the previous audit, these taxpayers were selected as potential candidates.
 - 3. Taxpayers with a large volume of exempt sales.
 - 4. New businesses.
 - 5. Business types - These traditionally have proven to be good audit candidates.
 - a. Manufacturers
 - b. Contractors
 - c. Professionals/Service Providers
 - 6. Auditor experience and expertise - with time and experience auditors develop a sixth sense and are able to identify viable candidates.
 - 7. AUDAP, and other Departmental reports and databases of registered taxpayers. The records in the databases can be queried and/or sorted by selected criteria in order to provide a useful listing for the identification of audit candidates.
 - 8. Complaints from the public
 - 9. Income tax returns
 - 10. Information gathered from other agencies and states
 - a. Federal – IRS

- b. State – ABC, DMV and VEC
- c. Local – Commissioners of Revenue
- d. Other States - SEATA

11. Other outside sources include the following:

- a. Media - This includes newspapers, radio, television and billboards. Look for advertisements, advertising inserts, news articles or segments on businesses.
- b. Dodge reports - These list contractors doing business or bidding to perform construction contracts in Virginia.
- c. Business journals and other publications.
- d. Internet - Review business web sites, identify products and their usage, locate businesses, etc.

C. Research - Once taxpayers have been identified as potential audit candidates, the auditor must use the resources available to him to determine if a taxpayer is actually a viable candidate for audit. This requires thorough research. This is the most important step in the selection process. Sources include:

1. AR/SEIBEL

a. IRMS Research – Audit Case Management System Overview

The Siebel Audit Case Management System (ACM) is a sub-system of the Siebel Customer Relationship Management application. ACM is directly integrated with ADVANTAGE Revenue (AR), Professional Audit Support System (PASS) and the Compliance Repository (CR). PASS uses models to query various criteria to identify potential audit candidates from data included in CR. While PASS and CR are not available to auditors in the field, much of this information is available in ACM. Also keep in mind that the ACM system is also utilized by our desk/office auditor staff so there are many fields and some view tabs that are not used by field auditors.

b. Siebel Research

There are two different Siebel applications for field auditors – Server Siebel (Siebel web-client) on TAX servers and Remote Siebel that resides on the local laptop. For research purposes, you should always use Server Siebel. (Most of the detail Siebel screens are not populated in Remote Siebel.) The following information can be found in Server Siebel:

- On the Audit Cases screen, query the FEIN to determine the audit history of a particular customer. This results in a list of all audit cases for a particular customer
 - All cases 2004 and forward
 - Includes workpaper archive for cases processed after August 2005

- Select the specific case that you wish to view – there is much information in the Audit Case Detail applet:
- Demographic information
- Case Type – Audit or Revised Audit
- Case Tax Type
- Compliance Code
- Description and Comment fields
- Tax Account Number
- Legacy Tax Account Number, if any
- Case Status
- Date Case Created
- Audit Span Period
- Waiver Information, if entered by auditor
- Recurring Audit Indicator and Date
- Audit Team Members
- Go the Determination view tab to see the audit results for those audits closed under ACM
- Go to the Workpapers view tab to review those audits closed under ACM
 - If you were part of the original audit team, you can go to Remote Siebel and query for the specific case: go to the Work paper view tab and then click the Review button.
 - You can do this even if you deleted the workpaper file from your laptop
 - It is possible that you may have to synchronize before viewing the audit
- If you were NOT part of the original audit team, in Server Siebel go to the Attachment view tab and download the most recent *.zip file to your local laptop.
 - Unzip it in the normal Audit Workbench path in the appropriate application folder
 - Use the file name for folder name choice from the WinZip menu
 - Then open the appropriate Audit Workbench application from the desktop to view the audit.
 - It is not possible to view audits directly from Server Siebel
- Go to the secure drive for closed audits to review audit workpapers for audits closed between 2002 and July 2005.
- Go to the Attachment view tab to ensure that you see files that may not have been included in the system generated *.zip and *.det files

- Some of the more common file you might expect to see are *.doc, *.xls, *.mdb, *.jpg and *.pdf files.
- Go to the Audit Trail view tab
 - A history of most fields on the Audit Case Detail applet that were changed while the audit was open can be seen here
 - Some work units use the Description and Comment fields to record a series of notations
 - Each comment is recorded in full on the Audit Trail
- Go to the Siebel Consolidated screen
 - View the Activities associated to your customer
 - Can access all incoming communications here
 - View the various flags such as bankruptcy, active CACSG case, etc.
- Go to the Siebel Customers screen
 - Go to the Tax Accounts view tab
 - Verify that the tax account you want to audit is listed there and that your audit span period is within the listed BLD/ELD
 - A new audit case cannot be created until the tax account information is properly listed in Siebel
- Go to the Compliance Repository view tab to see what source information is available.
 - Besides TAX data, there are usually entries from VEC and DMV that may have helpful information

c. AR Research

While research in ACM and Siebel can provide useful information, AR provides the best data to determine a customer's tax compliance. In the ideal situation, each customer will have only one Customer Profile, with all tax accounts associated to it. Since AR is the TAX system of record, all demographic and financial transactions are recorded here.

- Start your research at the Customer Profile
 - If you are already in Server Siebel, there are "AR-Customer Profile" hot buttons on most Siebel applets that take you directly to the same customer in AR
 - If not already in Siebel, simply query AR by FEIN, name, etc.
 - The Entity type is identified in the window title bar of the Customer Profile
- From the Customer menu you can:
 - View Affiliations

- This is important to determine parent/child relationships for corporations and for determining the tax accounts to which an individual is affiliated
- View Relationships
- For individuals, usually the spouse is the only relationship
- See Affiliations – where ties to businesses display
- View Bill Summary
- Besides outstanding and paid bills, non-filers are also noted
- View Notes
- Any notes made by TAX reps are viewed here
- If you add a note be sure to identify the specific tax account and the period(s) to which the note applies
- View AR Correspondence
- All incoming correspondence is viewed in Siebel, but outgoing correspondence is viewed in the application where it was created
- View Customer History
- History is system generated
- View the Address Manager
 - The various addresses will tell you where the business is located, where the records are kept, where the mail is sent, etc.
 - View the Business Location Manager (located in the Address Manager menu) to learn trade names, localities and association dates
- View the Tax Account
 - Totals tab is the default tab
 - Shows calendar year totals for tax paid
 - This is great for CU tax accounts because you can compare actual tax amounts between years
 - For ST and UT, however, you can only see the total tax paid
 - There is no way to see span totals in AR for just CU
 - Tax Account Tax Type tab has information such as the BLD, ELD, current filing status, seasonal filing status, combined or consolidated status, the old STARS number, if any, and other valuable data
 - Contact tab should list the contact for the specific tax account as well as telephone and fax numbers
- From the Periods tab you can view the balances of the individual Tax Account Periods (TAPs) or access a TAP
- From the Tax Account Menu you can:

- View Tax Account Entries
- Very helpful to get a quick overview of the entire tax account without having to view each individual TAP separately
- Shows all entries for all TAPs
- Double click a column heading and the display will automatically sort by that column heading
- Great for trying to figure out on what TAP a Stop has been placed.
- View the Tax Account History
 - General History includes BLD and ELD changes, etc.
 - Address History is important for multiple location audits
 - Only place where closed business locations display
- Go to an individual TAP
 - Details for each period are located here including all financial entries (returns, payments, bills, stops, offsets, additional interest, etc.)
 - Currently the AR TAP filter is OFF by default
 - Therefore, all entries are visible
 - You may want to use the Tax Account Period menu to turn the filter ON to eliminate offsetting entries
 - This step can make the TAP easier to understand
 - Many windows are not expandable in AR, but the Tax Account / Periods window and the TAP / Entries window are
 - By pulling down the windows to the maximum vertical length you can see much more information without having to scroll
 - If you access the return, you can go to the Return menu and select View Form to view the actual scanned document
- The Transaction Search is very helpful in these situations:
 - Need to view the return for each month
 - Use the Transaction Search icon and query for the FEIN, the specific tax, and use Returns for the transaction type
 - You can further limit to a specific period if desired
 - Please note that CU, Sales and UT are distinct taxes for this search
 - Saves several steps compared to going into each TAP to view the return
 - Find returns that are worklisted
 - Use the Transaction Search icon and query for the FEIN, all tax types and choose Work list Items as the transaction type

- If you locate worklisted returns you cannot save any changes to the return, but you are able to view the return to obtain figures
 - Search for W-2 forms
 - 2005 is the earliest available year for AR W-2 data
 - Click File, Close All to obtain a blank AR window – The Tax Information menu is now available
 - Select W-2 Information and enter the required information
 - Can query for all company W-2s or for an individual's SSN
 - For businesses that file a Pass Through Entity (PTE) return, be sure to view the scanned image which often contains the full federal return
 - For data prior to 2004, access the Panagon Report Manager
2. Compare information provided - results of last audit to current filings; amount of WH to amount of CU or volume of sales; gross receipts per income tax returns to sales tax returns; tax reported to tax reported by similar businesses.
 3. Inquiries - ask other auditors, employees, and local officials about their knowledge of the particular business in order to get a general feel for the business. Contact the business and ask questions.
- D. Make selection
- Weigh all the information you have reviewed in order to determine the feasibility of the candidate – potential compliance issues vs. time and other costs. To the extent possible, maintain a 'balanced' inventory of candidates: small, medium and large candidates.

Field Audit Procedures – Sales & Use



Tax Topic: Sampling & Front-End

Agreements Revised: September 2016

I. References

- A. Code of Virginia, as cited
- B. Virginia Administrative Code Title 23
- C. Public Documents:
 - PD 01-106 Record keeping
 - PD 01-96 Error Factor
 - PD 01-51 Credits Included In Sample
 - PD 01-50, PD 01-36 Isolated Transactions
 - PD 00-93, 01-130, 01-60 Withdrawals From Inventory

II. General

Sampling is an audit technique of significant value that is widely used in both the public and private sectors for all types of audits where a detailed audit would not prove beneficial either to the auditor or the client. When sampling techniques are applied, the final results are usually within a narrow percentage range of the actual amount that would have been determined by a detailed audit. The purpose of the audit sample is to determine a factor for errors within a representative selected period. Once the error factor is determined, the factor is extrapolated over the entire audit period. The purpose of the projection is to account for likely similar transactions on which Virginia tax has not been paid.

Audit sampling is examining less than all of the records of an audit period to determine the audit liability. Audit sampling is a technique used to compress the time required to perform an audit, and to minimize the volume of records examined. Sampling may be used in all types of audits. An audit period assessment that is based on a sample period and assessed by the Department of Taxation is prima facie correct and valid. The burden of proof that the sample is incorrect is upon the taxpayer.

An auditor should thoroughly “think through” the use of samples before beginning the audit. Audit sampling assumes that a rationally selected sample period is representative of the audit population. Consideration should be given to fluctuation in business and categories of transactions within the business as well as volume of records. The objective should be to choose sample periods which are representative of all transactions of the dealer in the audit period. Choose different periods for the different tax areas, if necessary.

In very large audits, the Department of Taxation has software that can aid in sampling. This software may be used with sales or purchases. An auditor experienced with the “Invoice Capture Tool” is available to work with field auditors on audits where the use of this software is beneficial. The software is used to stratify a population, or divide the population into relatively homogeneous subgroups called

strata. These strata then may be sampled separately; the sample results may be evaluated separately, or combined, to provide an error factor for the total population. Whenever items of extremely high or low values or other unusual characteristics are segregated into separate populations, each population becomes more homogeneous. It is then easier to draw a representative sample from which a smaller number of items may be examined in each strata than to sample the total population. In addition to increasing the efficiency of sampling procedures, stratification enables auditors to evaluate materiality and other characteristics of items and to apply different audit procedures to each stratum.

Fixed assets should not be included in the sampling procedure. These items are not purchases that have recurred during the audit period. Asset purchases which are expensed (IRC Section 179) should be detailed along with capitalized fixed assets. The depreciation schedule should show expensed asset purchases. Cross check Form 4562 from the federal income tax return; it will show the dollar value of Section 179 property and will clue the auditor to request purchase invoices for these items if not seen elsewhere.

III. Definitions

Audit Sampling is defined as the application of audit procedures to less than 100% of the population to provide a conclusion on the level of compliance with the tax laws.

Population refers to all similar transactions during an audit period. There may be multiple populations in an audit. See also "Sample Base".

Sample Period means the portion of the audit period which is reviewed in detail in order to project the findings over the entire audit period. Depending on the volume of records, the sample period may be days, weeks, months or years.

Sample Base means the data chosen to reflect the sample period for projection purposes over the audit period. Sample base usually conforms to the population of the sample period; but may be any consistent data on which the dealer and the auditor agree to use. For example, a sales audit with the month of May as the sample period may use gross sales (population) for the month of May as sample base to be used to arrive at an error factor to compute a liability/refund against gross sales for the entire audit period. The use of sales (population) data as a sample base in a purchase audit is an example of an agreed upon base.

Block Sampling means the use of all transactions in a selected period of time, combination of time periods, numerical sequence, or alphabetical sequence as the test period from which the sample is based.

Statistical Sampling means either the use of random-based sampling selection criteria, usually mathematically chosen random transactions throughout the audit period as the test for compliance; or systematic sampling criteria using a fixed interval between selections, the first interval having a random start. A computer program may be used to define and select transactions included in the sample.

Structured Nonstatistical Sampling means the use of defined criteria chosen by agreement between the taxpayer and the auditor as the test for compliance. For example, a recurring expense purchase sample may be used which contains only certain general ledger accounts that are identified to contain taxable transactions.

Error Factor refers to the percentage of records sampled which do not comply with the Virginia Retail Sales and Use Tax Regulations or the Code of Virginia. The error factor is computed by dividing the additional taxable sales/purchases by the gross sales/expense purchases reported for the period in question. Also known as **Margin of Error**.

Extrapolate means to infer or estimate by extending or projecting known information.

Rollup Method means to extrapolate the error factor evenly throughout the audit period. This assumes no fluctuation in business and produces a measure that is the same for all the periods in the audit. For example, a three-month sample in a three-year (36 month) audit period produces an untaxed measure of \$5,040.00. Rollup method would extrapolate \$1,680.00 per month or \$60,480.00 measure for the period.

Fixed Assets means depreciable property used in operating a business that will not be consumed or converted into cash or its equivalent during the current accounting period. Fixed assets also include property deducted under IRC Section 179. Assets may be deducted under IRC Section 179 if they are purchased for use in the active conduct of a trade or business and meet certain criteria.

Recurring Expense Purchases means non-depreciable ongoing purchases used in the everyday operation of a business.

Withdrawals From Inventory means the removal of tangible personal property from an inventory of items for resale for purposes other than resale.

Front-End Agreement refers to an agreement between the taxpayer and the Department of Taxation where the taxpayer will remit additional taxes on certain categories or general ledger accounts based on a single or multiple percentages which are derived from the results of an audit (either detail or sampled) of the taxpayer's records for a predetermined period of time. Front-end agreements usually cover prospective audit periods and reduce the amount of time needed to perform an audit.

IV. Procedures

A. To Sample or not to Sample

It is important to consider various aspects of the taxpayer's business when deciding on a sample audit. Some type of sample can usually be used on most businesses. An evaluation of the type of business and sampling opportunities should be done. The basic characteristics of the business and the method of reporting must be consistent throughout the audit period. If characteristics of the business change during the audit period, separate samples should be made for each specific period to determine the individual error factors for each period. A sample should contain sufficient transactions to produce an accurate error factor representative of the business as a whole.

Check the prior audit comments for the methods used by the prior auditor. Research payment record and returns data to get information on taxable and exempt sales and fluctuation of business. By entering data into the STAUDN returns data screen, the program can be used to identify potential sample

periods using various criteria. Does the return data appear to be correct in that gross sales and exempt sales are being reported on the return rather than just taxable sales? Ask the question in the initial contact if there is doubt. This may affect the periods chosen for sampling. Is there any familiarity with the nature of the business and the type of customers (exempt versus taxable)? Is the taxpayer selling to industrial and commercial customers? Are the invoice amounts on average small amounts? Is this taxpayer a multi-state dealer? What portion of total sales are Virginia sales?

The auditor should use the initial contact to obtain information about the business which will aid in the decision of whether or not to use sampling and the methods of sampling which would be most effective to obtain an accurate result. Inquire about the volume, nature & seasonality of the business, volume and organization of records, changes in accounting methods, software, and personnel responsible for administering taxes. Are invoices available in hard copy for will you be able to view them on computer screen? Some companies now have the capability to download information to disk for your viewing on your computer.

Suggest to the taxpayer that a sample audit could be done to minimize the number of records and time needed to do the audit. Time and effort are as important to the taxpayer as they are to the auditor. Discuss sampling and share with the taxpayer the statistics from the returns screen data. Ask the taxpayer to be thinking about sample period(s) that would be representative of the overall business during the proposed audit period and for which records are readily available. This will give him period(s) to consider and time to evaluate the sampling concept.

At the beginning of the audit, review sampling again. By this time, you have evaluated the possibilities and opportunities for sampling from your initial conversation with the taxpayer. Now is the time to firm up the sample period and consider methods. Be sure the dealer understands the mechanics of sampling and agrees to the months selected. Remember that taking the time to fully explain how the audit process works generates goodwill and makes finalization much easier for both parties. When a sample is performed, a signed sample agreement from the dealer detailing the sample period and extent of the sampling may be desirable. Signed sample agreements can defuse later challenges to the validity of the sample. The sample agreement should note the sample period and class of transactions being sampled (sales, purchases). The auditor should inform the taxpayer or his representative that signing a sample agreement does not jeopardize his right to contest or appeal any portion of the audit with which he is not in full agreement.

Exemption certificates should be examined before beginning sales samples. This examination will alert the auditor to large volume, exempt customers and also give a warning to potential liability based on the information contained on the exemption certificate as well as helping to identify which customers for which exemption certificates are not on file. Title 23 of the Virginia Administrative Code (VAC 10-210-280) explains that the burden of proving that the tax does not apply rests with a dealer unless he takes, in good faith from the purchaser or lessee, a certificate of exemption indicating that the property is exempt under the law. A certificate that is incomplete, invalid, infirm or

inconsistent on its face is never acceptable. The regulation further provides that an exemption certificate cannot be used to make a tax-free purchase of any item of tangible personal property not covered by the exact wording of the certificate. Therefore, the seller must use reasonable care and judgement in selling tangible personal property exclusive of the tax, even when an exemption certificate from the purchaser is in his file. Furthermore, certificates of exemption obtained during or after an audit situation will be accepted only if the auditor can confirm that the customer's use of the certificate was valid and proper for the specific transaction.

B. Sample Design

Sample design covers the method of selection, the sample structure and plans for analyzing and extrapolating the results. There are many ways in which a sample can be selected. If the volume of invoices is small, larger sample periods may be selected. Detail audits may be appropriate when they can be accomplished in a short time frame. This allows the auditor to examine all facets of the business, which may reveal other audit opportunities. A combination of methods may be the answer, depending on the circumstances.

1. Records

Code of Virginia 58.1-633 requires every dealer "to keep and preserve suitable records of the sales, leases, or purchases . . . and such other books of account as may be necessary to determine the amount of tax due hereunder, and such other pertinent information as may be required by the Tax Commissioner". When a dealer fails to maintain adequate records, the department is authorized by Code of Virginia 58.1-618 to use the best information available to reconstruct a dealer's sales or purchases to determine whether a tax liability exists. A sample of records on hand may be used to reconstruct data for an audit. Cancelled checks, credit card statements, bank deposits, items of public record, or statements by the taxpayer may be used when there are no records available. Any sample projected on this basis is considered prima facie correct.

2. Sales

How are the records organized? Block sampling is particularly useful in sales audits and is the historical method used by department auditors. If sales invoices are available by invoice number in date order, the sample period could be a block of invoices less than a year. Monthly sales journals give flexibility to examine one-month blocks and tie tax collected to returns. If the only invoice information available is by customer by year, the auditor may have to examine an entire year of invoices to see all invoices.

If the business is seasonal, both the auditor and the taxpayer must be satisfied that the time block is representative.

Statistical sampling is useful in sales audits where the volume of transactions is large. In the best of audit environments, a sample chosen based on the volume of the dealer is preferable. Usually, a one-month to three-month sample is adequate. When transactions are fairly consistent, choose an average month as a sample. A three-month sample selecting one month from each of the three years of the audit period, or using the high, low and average months as indicated by the return statistics are

additional options. If you are auditing a particularly large business such as a manufacturer or retailer, consider a much smaller sample, such as one week.

If there are different categories of sales where dollar amounts fluctuate, such as equipment sales, parts sales, and repair sales, you may want to use a combination of sample methods or a combination of sample and detail methods.

3. Purchases

Review the chart of accounts to identify which accounts are used for charging taxable purchases. Make a note of construction-in-progress and other suspense accounts used to initially charge depreciable assets. These accounts should be examined for purchases that may be reclassified and capitalized later. Negotiation with the taxpayer may be necessary to separate the items to be considered assets and those that may be included in the expense purchase sample. Also note intercompany accounts which may contain charges not seen elsewhere.

The method used for sampling purchases should be determined by the size of the taxpayer and their filing system. Many taxpayers file purchase invoices by vendor, by year. The year may be calendar or fiscal. If the volume of records is small, a one-year block sample may be advisable. By scheduling the audit near the end of the first six months of the year, the use of a six-month sample period instead of an entire year would be possible.

If purchase invoices are batched and filed by voucher number sequence or by pay dates, there is much more flexibility in negotiating a sample period with the taxpayer that is smaller than twelve months, and covering more than one year of the audit period. Statistical sampling is a good choice where the number of transactions is very large.

The general ledger detail or an accounts payable ledger for a chosen sample may be used to select invoices to be examined. This can save time over looking at all the invoices in a sample period. Use of the general ledger assures that you are seeing all the transactions during a certain period. This can be valuable when there are intercompany charges for which no invoice is present. Remember to consider withdrawals from inventory, which may or may not show up on the books of the taxpayer.

C. Unusual Items

There is always the possibility that isolated errors may occur which are not typical of a taxpayer's operations. For an item to be removed from an audit sample, a taxpayer must establish that the transaction was an isolated event and not a normal part of its operations. Allow the taxpayer to produce documentation that this was an isolated event and not a part of his regular course of business.

Before any item of unusual circumstance is omitted from the sample, the auditor should thoroughly analyze and discuss the situation with the Audit Supervisor. Factors that should be taken into consideration before an item is excluded or included are: the size of the item is excessive compared to the normal items and occurs only at rare intervals; the sale or purchase is a type not ordinarily handled; or the item involves some unusual circumstance.

Consider expanding the sample or reaching a compromise that would be fair to the taxpayer and to TAX.

D. Credits Against the Sample

1. Sales

When conducting a sales audit the taxpayer has the legal right to bill its customers for the sales tax not originally collected. Those customers may have been audited, or they may have properly accrued the untaxed sale made to them. Most taxpayers feel that in this case, the exception should be removed from the sample; however, this is not a reason to remove the sale from the sample. A one-time credit is given on a separate schedule when it is established that a customer has paid the tax. This is done because there are likely similar transactions outside the sample period on which the tax has not been paid. To remove the exception would invalidate the sample. The likelihood that every other customer with a similar transaction in the other months of the sample accrued and paid the tax is remote.

2. Tax Collected in Error

Taxpayers who have nexus in other states sometimes collect taxes from their customers based on the customer's location rather than the ship to location. This erroneously collected tax is remitted to the other state rather than Virginia. Any dealer who collects tax in excess of a 5% rate or who otherwise overcollects the tax, is required to remit the over collection to the state. Virginia sales where the taxpayer has collected another state's tax are included in the sample using a measure amount to recover the amount of tax collected. If the taxpayer elects to research over collections and either refund or credit the customer's account, a credit may be taken on a future return.

3. Expense Purchases

Sometimes it is impossible to trace accruals from the return to an invoice. In these instances, the best approach is to list all untaxed taxable purchases made during the sample period and all untaxed taxable fixed assets acquired during the entire audit period. Extrapolate the sample measure and give credit for the measure accrued on a separate schedule. This should produce an audit liability that allows for the following:

- a. Inconsistent accrual of use tax.
- b. Accrual of use tax based on a percentage of sales, or some fixed dollar amount.
- c. Inability to identify the invoices and/or items accrued.

4. Tax Accrued in Error

Taxpayers may accrue tax on nontaxable purchases. A credit is given on the sample schedule for any tax accrued in error during the sample period. If the taxpayer accrued it in the sample period you examined, it is likely he accrued in other periods as well.

5. Tax Paid in Error

Many times, taxpayers do not check their invoices to determine that Virginia tax is being correctly charged by their vendors. No credit is given for another state's tax paid in error. It is the taxpayer's responsibility to get a refund from the vendor for any tax paid in error. The purchase is included in the sample as if it was an untaxed purchase.

V. Reporting the Results

A. Sample Bases or "Population" and Error Factor

Sales tax return data is usually used as the base for extrapolation of sales samples. If it is discovered that the taxpayer has reported only taxable sales on line 1 of the sales tax return, using sales data from financial statements may be a better alternative to using return data. Accounts payable totals are generally used for purchase samples. The STAUDN software uses the total of untaxed exceptions as the numerator of a fraction, of which the denominator is the total of the sample period data in the sample base, to arrive at an error factor which is then extrapolated or multiplied by the data for each month in the sample base. This gives the measure amount for the audit liability.

If a rollup is done (not recommended for sales), the base would be the same number for each of the months during the audit period. Rollups are used to project the same measure amount (and audit liability) for each month throughout the audit period.

B. Error Factor Computation Example

This example has been prepared to provide an illustration of how the error factor is computed from the sampling procedure, how it is applied to the sample base to determine the taxable measure, and the effects of "altering" the sample base. In our example, the audit period is April 2006 – March 2009.

The taxpayer has provided a schedule of Accounts Payable debit TOTALS for each month of the audit period. These monthly totals will be used as the "Sample Base" or "Population" for extrapolation purposes. AP debit totals are generally acceptable for the base as they accurately reflect the trends and expenses for the company, and are readily available. From these monthly totals, our sample months (high, low, average) were selected for review. From each sample month, general expense purchase invoices are reviewed. All invoices where tax was not paid on the invoice or accrued and remitted to the State are listed as purchase exceptions.

For our example, the total untaxed purchase exceptions from the sample months are \$270,517.83.

Our sample months are: May 2007, Feb. 2008, and Jan. 2009

For our Original Computation, the sample "Population" from our sample period will be:

<u>Period</u>	<u>Total AP Debits</u>	<u>Total Exceptions</u>
0705	\$3,140,614.84	\$270,517.83
0802	\$4,510,766.69	
0901	<u>\$6,020,671.52</u>	
	\$13,672,053.05	

This represents the total Accounts Payable disbursements from the sample months. The error factor is computed as follows:

$$\frac{\text{Total Exceptions}}{\text{Population}} = \text{Error Factor}$$

$$\frac{\$270,517.83}{\$13,672,053.05} = .019786189$$

The error factor from the sample periods indicates the percentage of the total disbursements that were not taxed. It is assumed that there will be a similar rate of error in the remainder of the months of the entire audit period. Therefore, the error factor from the sample periods is applied to the "Sample Base" for the entire audit period to determine the total taxable measure identified by the audit. With total AP for the audit period of \$170,902,694.17, the extrapolated total of \$3,382,513.01 now becomes the taxable measure (\$170,902,694.17 X .019786189).

For Computation Two, assume that the taxpayer requests that certain disbursements be removed from the extrapolation base, i.e.: salary, insurance, etc. since these represent non-taxable amounts. For the example, assume that these monthly disbursements are 13% of the total.

The error factor the second computation will be as follows:

<u>Period</u>	<u>Total AP Debits</u>	<u>Total Exceptions</u>
0705	\$2,732,334.91	<u>\$270,517.83</u>
0802	\$3,924,367.02	\$11,894,686.15
Population		
0901	<u>\$5,237,984.22</u>	
	\$11,894,686.15	Error Factor .022742746

Reducing the AP by 13%, the AP total is \$148,685,343.93. The extrapolated taxable measure from Computation Two is \$3,381,513.01 (\$148,685,343.93 X .022742746). No difference from Computation One. Although it would seem at first thought, reducing the sample base will reduce the potential tax liability; the only thing that changes is the error factor. The net result is that the error factor went up, and you are now essentially taking a bigger "bite" out of a smaller pie.

The most important factor in determining the computation of the audit is the total of untaxed exceptions. This total is what will determine the error factor to be used in the extrapolation of the sample base

C. Penalty

The application of penalty to audit deficiencies is mandatory and its application is generally based on the percentage of compliance determined by computing the dealer's compliance ratio. The compliance ratio for the sales or use tax is computed by using the following formula:

$$\frac{\text{Measure Reported}}{\text{Measure Reported} + \text{Measure Found}} = \text{Compliance Ratio}$$

Measure reported means dollar amounts of sales or use measure reported on returns for the audit period. "Measure found" means dollar amounts of additional sales or use measure disclosed by the audit. Separate ratios for sales and use

taxes will be necessary if the audit contains deficiencies in both areas. The STAUDN software automatically computes compliance ratios based on returns data entered. Tax paid to vendors will not be included in the computation of the compliance ratio for the audit period. See Alternative Method for Computing Compliance Ratio for additional taxpayer options to avoid the penalty.

1. First generation audits- Generally, penalty cannot be waived if any of the following conditions exist:
 - a. The taxpayer has been previously notified in writing to collect tax on sales or to pay tax on purchases, but has failed to follow instructions; or
 - b. The taxpayer has collected the sales tax, but failed to remit to the Department of Taxation; or
 - c. There are indications of fraud in which the taxpayer has willfully evaded reporting and remitting the tax to the Department of Taxation.
2. Second-generation audits- Penalty will be applied unless the taxpayer's compliance ratios meet or exceed 85% for sales tax and 60% for use tax.
3. All subsequent generation audits- Penalty will be applied unless the taxpayer's compliance ratios meet or exceed 85% for sales tax and 85% for use tax.
4. Alternative Penalty Method- If penalty is applied based on the department's calculation of the use tax compliance ratio, the Taxpayer will have the option of calculating the use tax compliance ratio, under the Alternative Method, as follows:

$$\frac{\text{Measure Reported} + \text{Measure Paid to Vendors}}{\text{Compliance Ratio}} =$$

Measure Reported + Measure Paid to Vendors + Measure Found

It is the Taxpayer's responsibility to compute the above compliance ratio and provide the auditor with documentation supporting the computation. The Taxpayer must compute the alternative ratio based on a review of purchases for the same period used by the auditor to compute the traditional compliance ratio. Tolerances for the Alternative Method will remain the same as those of the traditional compliance ratio.

If it is determined that use tax audit penalty is applicable based on the traditional compliance ratio calculations, the auditor will advise the Taxpayer. If the Taxpayer desires to recalculate the compliance under the Alternative Method, the auditor will assess the audit penalty as a contested issue. The Taxpayer must complete the Alternative Method calculations and provide the documentation to the auditor within 60 days of the audit assessment. If the use tax compliance falls within the acceptable tolerances based on the Alternative Method calculations, the audit penalty will be abated.

VI. Front-End Agreements

Front-End Agreements have traditionally been used for taxpayers that are manufacturers or holders of direct payment permits and are recurring three-year cycle audit candidates. The agreement covers the expense purchase portion of the

audit. The taxpayer and the Department of Taxation agree that the tax will be paid “on the front end” rather than at audit time.

An audit is done and areas are identified where compliance is not being met. In the case of a manufacturer, the agreement may be to remit an additional amount of use tax based on the error factor in the audit; or an additional amount or percentage of use tax based on account transaction information. The direct payment permit holder may agree to remit tax based on the error factor of the audit, on accounts payable data, or, for certain accounts which were found to be totally taxable, tax would be remitted on the activity in these accounts. A written agreement is drafted and signed by both parties. In subsequent audits, the auditor does limited “testing” to determine that the agreement is being followed. This “testing” would also determine whether or not the percentages need to be adjusted for the next audit cycle. Negotiations with the taxpayer would fix the agreement for the subsequent audit period.

Fixed assets are audited in detail each audit period. Front End Agreements substantially reduce the amount of time needed to complete an audit.

Field Audit Procedures – Sales & Use Tax



Topic: Invoice Capture Tool Policies & Procedures

Revised: September 2016

I. Overview

The Invoice Capture Tool (ICT) program introduced by the Office of Compliance in January 2000 will enhance the software that the Virginia TAX field audit staff uses. The current audit process involves extensive manual searching through taxpayer paper invoices. The ICT initiative will deliver software that will allow ICT auditors to receive this information electronically from taxpayers. Furthermore, this new software will significantly reduce the burden of the taxpayer, increase the accuracy of the audit, and decrease the time it takes for an auditor to complete an audit.

This document outlines the policies and procedures for the ICT audit program. The initial ICT rollout involves a limited number of TAX audit personnel. Through increased usage of the ICT software, TAX may consider expanding the ICT Audit Program. The purpose of the ICT Policies and Procedures is to provide a framework for the limited ICT rollout. As the ICT program evolves, the Policies and Procedures will be updated to incorporate any necessary changes to the ICT Audit Program.

II. ICT Audit Candidate Determination

A. Identifying ICT Audit Candidates

The first stage of the ICT Process involves the identification of audit candidates. The audit selection process employed by OOC involves the regional managers auditors, and the TAX Audit Selection program for identifying ICT audit candidates. Using the Central Audit Selection program will permit the selected candidates to be assigned directly to the ICT Support Team (IST) for assignment to Audit personnel. Additionally, referrals from auditors and regional managers will be used for identifying ICT audit candidates.

In addition to the centralized audit selection process, the following processes will also be used to identify ICT audit candidates.

- *Evaluate current audit inventory:* all regional managers and auditors will be encouraged to evaluate their current audit inventory to identify taxpayers that may qualify for an ICT audit.
- *Field audit leads:* Regional managers and auditors should evaluate new audit leads to identify taxpayers that may qualify for an ICT audit.
- *Collection referral audit leads:* All audit leads provided by Collection personnel should be reviewed and evaluated for qualifying as a possible ICT audit candidate.
- *Audits at the request of taxpayers:* All taxpayers that request an electronic audit will be considered as a potential ICT audit candidate. The ICT Auditor and the regional manager will evaluate the feasibility of conducting an ICT audit on this taxpayer.

B. Qualifying criteria for an ICT Audit Candidate

Upon being assigned an audit, the auditor after reviewing the assignment, should immediately contact the taxpayer to coordinate and establish the audit schedule, and arrange for a pre-audit conference with the taxpayer. All field auditors will be trained on the policies and procedures employed by TAX for identifying and qualifying ICT audit candidates. Additionally, detailed documentation outlining the policies and procedures will accompany this training. The auditors will conduct their standard pre-audit conference and determine the feasibility for conducting an ICT audit.

After the successful identification of an audit candidate, the auditor must determine if the ICT program should be used to facilitate the audit process. It is the responsibility of the audit staff to determine if an individual audit candidate would be feasible for utilizing the ICT audit tool. Field auditors should consider the following issues when making the determination:

- Does the taxpayer have an automated chart of accounts?
- Is the taxpayer's general ledger updated from posted information?
- Is the taxpayer willing to download data?
- Does the taxpayer want to participate in an ICT audit?
- Will the use of the ICT audit program reduce the amount of time needed to complete the audit?
- Will the use of the ICT audit program reduce the amount of time needed to complete the audit?
- Has the taxpayer's accounting system been consistent for a known period of time (i.e. consistent accounting codes and methodology)?

C. Technical Feasibility for conducting an ICT Audit

Upon the identification of a potential ICT audit candidate, the auditor will arrange a meeting with the ICT Auditor, and the Taxpayer to discuss the technical feasibility of using the ICT audit tool for conducting the audit. The auditor should directly contact the ICT Auditor when they are located in the same region . Otherwise, the auditor should contact the IST, who will then identify an ICT auditor in a neighboring district. This audit team (the auditor, and the ICT Auditor) will arrange a second pre-audit conference with the taxpayer to discuss the technical feasibility for applying the ICT software to the audit assignment.

The following factors should be considered when analyzing the technical feasibility for using the ICT audit program.

D. Data Format

The ICT software (IDEA) can work effectively with a wide array of data formats. These formats include one or more of the following applications:

Application Data and Databases

- Access
- Lotus 123

- Oracle
- Various accounting packages including Accpac, Simply Accounting, Pegasus, Sage, and many others
- Btrieve
- Excel
- SQL Server
- Sybase
- Xbase (the DBF format from dbase, foxpro, and others)

Flat Files/ unformatted DATA

- ASCII (fixed length and variable length)
- EBCDIC (fixed length)
- AS/400 DIF (Data interchange Format)
- ASCII Delimited
- EBCDIC (variable length ANSI/IBM)

Most software applications can effectively export a flat, or ASCII, file type. The ICT Auditor should work with the taxpayer to identify a usable file format.

1. File Size Limitations

The largest file that IDEA can handle is 2.1 gigabytes, unless the auditor is working with ODBC data (application data – Excel and Access), in which case you can access files that are much larger. The 2.1 gig limit is a function of the operating system rather than a limitation of IDEA. The 32-bit version of IDEA will overcome this limitation. IDEA can handle files with up to 2.1 billion records and files with up to 32,766 fields per record.

For additional information, view IDEA website at www.cica.caiidea/v3faq.htm or the user manual accompanying the IDEA software.

2. Fields Available Electronically

The ICT Auditor must ensure that the appropriate data is available to effectively conduct the audit. The ICT and District Auditors should work with the taxpayer to identify the fields that are available electronically.

The following fields are required to perform an audit, based on gross sales:

- a. Customer name and/or account number
- b. Amount of sale
- c. Sales tax collected (if any)
- d. Ship to location
- e. Date of sale
- f. Description of the item sold

The following fields are required to perform an audit, based on purchases:

- a. Vendor name and/or account number
- b. Account number that the purchases are being charged to
- c. Sales tax paid to vendor, when separately stated
- d. Date of purchase
- e. Cost of item
- f. Description of item purchased
- g. If no sales tax paid to vendor, is accrual being posted?

As documented in Section IV: (Technical Aspects of the ICT Audit Process), many of these fields can be directly imported into the STAUDN exceptions list. Additionally, many of these fields can facilitate the generation of an exceptions list in the ICT software, but may not need to be imported into STAUDN.

III. Successful Identification of an ICT Candidate

A. Recommendation to IST (Audits Outside the Region of an ICT Auditor)

Upon the successful identification of an ICT audit candidate from sources outside the district, the ICT Auditor will review the audit candidate with the Regional manager and will be notified who the auditor is that will be assigned the audit.

B. Recommendation to IST (Audits within the Region of an ICT Auditor)

Upon the successful identification of an ICT audit within a District, the ICT Auditor will contact the auditor in charge of the assignment to discuss the details of how the ICT audit procedures will be used. The auditor will follow the criteria outlined below for developing a potential ICT audit.

The IST will use the following criteria when approving an ICT audit candidate.

- Feedback from the auditor
- Documentation reviewed for the following:
 1. Business classification for the audit candidate
 2. Special audit issues and/or tax policy concerns regarding the business classification.
 3. Availability of ICT Auditor resources
 4. Geographic location of audit candidate
 5. Current inventory of the Region where the ICT audit candidate is located
 6. Feedback from the Regional Manager.

IV. ICT Audit Team and Roles of Individual Players

A. Key Players in the ICT Audit Process

- The District Audit Supervisor: Coordinates ICT audits with the District audit plan
- The District Audit Staff: All OOC audit personnel

- The ICT audit staff: Four auditors, one from the Central Regional area, Mindy Stembridge. Two from the Northern region, Ramin Amiri and Tom Budsock. One from the Interstate Audit unit, Mark Forster. As the ICT program expands, additional auditors will be added.

B. ICT Support Team(IST) members are: Jim Mason, Director of Field Audit, and Rob Roy, Supervisor Special Audits Tax Team.

The primary objectives of the IST support team will be to ensure the standardized use of the ICT software, to identify new opportunities for the use of the ICT software, and to manage the expansion of the ICT program. Through the use of a centralized team, TAX can closely manage and assess the effectiveness of the use of this new auditing tool.

The IST will perform a wide array of tasks, to include measures of performance for the ICT program.

The team leader will provide the Special Audits Tax Team Supervisor a monthly report on the status of new ICT cases that were begun during the month. All ICT auditors will submit to their team leader, the identification of all new cases. The team leader will compile and consolidate, and forward the report to the Director of Audits. The report will also be forwarded to the IST support team.

At the completion of the fiscal year, each ICT Auditor will submit a completed time savings report to the team leader. The report will be forwarded to the Assistant Tax Commissioner. Copies of this report will also be provided to the Director of Audits, and to the IST support team.

C. ICT Auditor (Audit Team)

The role of the ICT Auditor involves a wide array of technical and analytical processes. Through the course of the ICT training, auditors will learn to perform the tasks needed to electronically capture the taxpayer data and perform the requisite analysis. These tasks include:

- Understanding and, if necessary, defining the layout of the data
- Assessing the taxpayer's data file formats, and determining if any compatibility issues exist.
- Working with the taxpayers technology representatives to perform the data transfer
- Generating queries to extract specific records from the taxpayer's file
- Statistically analyze the taxpayer's file
- Importing and Exporting databases
- Working with external storage devices (i.e. Jaz drives and Superdisks) to facilitate the data importation process

The ICT Auditor will work with the auditor to perform the tasks needed to complete an audit. In addition to the aforementioned technical roles, the ICT Auditor will be responsible for:

- *Working with the field auditor to schedule ICT audits:* Upon being notified of a potential ICT audit assignment, the ICT auditor will work with the auditor to

schedule a second pre-audit conference. The ICT audit team should gather sufficient information that will allow them to qualify the candidate as an ICT audit candidate. Additionally, the audit team will determine the overall audit schedule during the audit conference.

- *Working with field auditors to recommend ICT audit candidates:* Upon completion of the second pre-audit conference, the ICT Auditor should work with the field auditor to determine if the ICT software will benefit the audit process.
- *Reviews the results of the ICT analysis with the field auditor:* After generating an exceptions list using the ICT software, the ICT Auditor will review the list with the auditor. The ICT Auditor and the auditor will review the exceptions list, IDEA log file, and any additional documentation to ensure the results meet the audit strata defined by the audit team. Additionally, this information may be included in the final audit report.
- *Imports data into the STAUDN worksheet on the field auditor's laptop:* Upon agreeing on the exceptions list, the ICT Auditor will assist the auditor in importing the exceptions list into the auditor's STAUDN worksheet.

D. Auditor (Audit Team)

Auditors serve as the primary auditor on all ICT audit assignments. As the primary auditor, the District Auditor will be responsible for:

- Contacting the taxpayer to schedule a pre-audit conference, and schedule the audit
- Serve as the primary liaison between the taxpayer and TAX
- Working with the taxpayer to arrange the data transfer
- Writing a confirmation letter (using approved template) to ensure the agreed upon approach and data requirements are explicitly documented
- Developing audit program and schedule
- Performing the audit field work
- Concluding the audit activities and review audit results with the taxpayer
- Generating the final audit reports
- Generating assessments, and/or refunds
- Coordinating the ICT audit assignments with the appropriate District Audit Supervisor

District Auditors serve as the primary link between the ICT audit program, and the taxpayers. To support the use of the ICT software, auditors need to communicate the benefits of the ICT program to the taxpayers, and should continuously try to identify potential ICT audit candidates. Upon identifying a potential ICT audit candidate, the auditor should contact the ICT Auditor to arrange a second pre-audit conference with the taxpayer. The auditor, and the ICT Auditor will work together to determine the feasibility for applying the ICT software on the identified potential ICT candidate.

As part of the ICT audit team, the auditor will work with the ICT Auditor; the auditor will import the data into the STAUDN audit template on their laptop computer. Furthermore, the auditor will complete the remainder of the audit activities, and present the results of the audit to the taxpayer. Although the auditor will report directly to the IST in Richmond, they will participate in completing the assessment for the completed audit, (i.e. benefits, issues, and recommendations).

As a part of the ICT audit team, the auditors need to communicate the benefits of the ICT program to the taxpayers, and are to continuously try to identify potential ICT audit candidates. Upon identifying a potential ICT audit candidate, the auditor should contact an ICT Auditor, and arrange a second pre-audit conference with the taxpayer. The auditor, and the ICT Auditor will work together to determine the feasibility for applying the ICT software for all audit candidates.

As a part of the ICT Audit Team, the auditor will work with the ICT Auditor in the generation of an exceptions list. With the assistance from the ICT Auditor, the auditor will import the data into the STAUDN audit template on their laptop computer. Furthermore, the auditor will complete the remainder of the audit activities, and present the audit results to the taxpayer. Although the auditors will not report directly to the IST in Central Office, they will participate in the preparation of the assessment of the audit results (i.e. benefits, issues, and recommendations).

V. TECHNICAL ASPECTS OF THE ICT AUDIT PROCESS

A. Data Retrieval

During the second pre-audit conference, the ICT Auditor and the District Auditor will work with the taxpayer's technical team to discuss the data retrieval requirements. The audit team should consider the following:

- *File Format*: The audit team should work with the taxpayer's technical team to identify an acceptable format (Section I-C: Technical Feasibility of the ICT Audit). To facilitate the data importation process, the audit team should try to obtain a file in either an application file format (i.e. Access or Excel) or in a fixed ASCII file layout.
- *File Size*: The audit team must consider the file size limitations associated with a floppy diskette (1.44 MB), super floppy diskette (120MB) CD (700 MB) or DVD.
- Storage devices will be available to the audit team when transferring files.
- *Taxpayer willingness to work with the super floppy drive*: When transferring data using a super floppy diskette, hardware drivers need to be installed on the source computer. Taxpayers must agree to use an external super floppy drive on their computer. Additionally, a representative responsible for the taxpayer's information system should perform the installation process.

B. Data Analysis

When using the ICT software to generate the exceptions list, the auditor should consider the following:

- Target a small percentage of transaction volume to achieve a high percentage of dollar coverage.
- Data analysis and manipulation will be performed on like transactions.
- Completeness testing on all areas of ICT audits must be performed on the front end of the data manipulation process.
- The ICT Auditor will maintain a log of activities for each ICT audit assignment, which details file manipulation, file names, and data analysis. WIN IDEA produces a log file that tracks these activities.
- The ICT Auditor will provide the audit comments as they pertain to the data manipulation process. Per the District Auditor’s discretion, the comments may be incorporated into the final audit report. The ICT Auditor will also maintain a copy of the comments in their own files.

The methodology employed when analyzing taxpayer data will be established as the ICT audit program matures. The ICT auditors should continuously communicate their data as identified and approved. This data will be documented in the Data Analysis section of the ICT Policies and Procedures.

C. Import Data into STAUDN:

The STAUDN audit worksheet contains a file importation feature. Using this feature, the District Auditors can import the ICT produced output (i.e. the exceptions list) into STAUDN. This importation process will create new records in the taxpayer exceptions list. Note that this process appends the existing exceptions list, and does not write over the existing records.

Prior to importing the exceptions list into STAUDN, the ICT Auditor must perform the following critical steps:

- Review the exceptions list with the District Auditor. It is essential that the ICT Auditor and the District Auditor agree on the exceptions list prior to importing it into STAUDN.
- Identify and rename the fields in the ICT database to names recognized by STAUDN. STAUDN will only import fields that have specific names. The following table lists the fields that can be in the import file:

Field Name	Type	Description	Format	Notes
Invoice Date	Date	Field holding, Month, Day and Year on Invoice	Any valid date format	Field cannot be left blank
Measure	Text	Measure type of invoice		Interface has Auditor math values in this field to STAUDN measures. Any blank values in field will also be mapped to STAUDN
Locality	Text	Locality to use Distribution		Must be blank or valid numeric locality code
Invoice Amount	Text	Amount on invoice	Can have \$'s if needed	Field cannot be left blank
Account Number	Text	Taxpayer's Chart of Account No.		
Items	Text	Descriptions of item on Invoice		
Invoice Number	Text	Invoice number used by		

		taxpayer		
Vendor Name	Text			If blank, invoice will map to a New vendor named "Imported"
Comments	Text	Comments about invoice		
UD1	Text	Custom field 1		
UD2	Text	Custom field 2		

NOTE: At a minimum, the INVOICE DATE and INVOICE AMOUNT fields must be included. Fields included in the files that are not listed above will simply be ignored.

- Export the approved exceptions list to an Access 2.5 file. This feature is located under File Export in the IDEA 3.0 software.
- Save the Access 2.5 file to a diskette or CD.
- Import the Access 2.5 file into the District Auditor's STAUDN audit file. This function is located under File Import in the STAUDN work sheet.
- Identify the measures corresponding to individual exceptions. This procedure can be done during either the file importation process via the File Importation Wizard, or during the generation of an exceptions list in the ICT software.

D. Return Taxpayer Data and Archive IDEA Files

After successfully importing the taxpayer data into STAUDN, and concluding all audit activities, the taxpayer data should be returned to the taxpayer in its original format. Additionally, all manipulations of the taxpayer data should be explained to the taxpayer and archived. These manipulations include all IDEA 3.0 audit files.

VI. ICT AUDIT RESULTS REVIEW AND EVALUATION

A. Overview

The review of the effectiveness of the ICT Audit Program is the responsibility of the ICT Support Team (IST) Team Leader. To support the achievements of the ICT Audit Program, standard criteria have been developed to assist the IST and TAX management, reviewing and evaluating the effectiveness of the ICT audit program. These criteria will track the monthly number of ICT audits begun, and the yearly savings in time.

B. ICT Report of Audit Results

At the completion of each ICT audit assignment, the ICT audit team will complete the ICT Savings Report on the Savings Report Form, and the Monthly List of new ICT audits by completing the following steps:

1. This is accomplished by computing the number of actual invoices reviewed compared to the total population of invoices in the original file. This number is divided by 1000 (average number of invoices reviewed per day) to determine the number of days saved.
2. This number is combined with the number of records imported into STAUDN by the ICT auditor. This is computed by dividing the total number of records imported by 200 (average number of records keyed in one day).

3. The two amounts will result in the total savings of time by using the ICT audit program. The amount of time is multiplied by \$300 (average value of time to complete an audit based on the past history of closed audits).

C. Communicating the Results of the ICT Audit Program

The ICT Audit Program involves many OOC resources. In addition to the ICT Auditors, all Audit Supervisors, and District Office Audit personnel will be involved in the ICT audit program. In an effort to involve all relevant personnel in the ICT audit program, the ICT Auditors, and the IST should continuously inform TAX management, the Audit Supervisors, and the District Auditors on the status, and the results of the program. The ICT Auditors will distribute the appropriate reports to management in the Office of Compliance, and the appropriate TAX personnel. In this manner the program will remain visible to all employees, and will promote the increased usage of the ICT audit program.

Field Audit Procedures – Sales & Use Tax



Topic: Statistical Sampling Procedures

Revised: December 2012

I. Introduction

The Virginia Department of Taxation uses statistical sampling, in conjunction with various other methods of sampling, where examination of 100% of the taxpayer's records is not feasible. This section will address the statistical sampling procedures used by the Department as part of our overall ICT (Invoice Capture Tool) program. The policies and procedures for the ICT program have all ready been established and approved. This section will become an addendum to the procedures for using ICT.

The objectives of the Department in incorporating the use of statistical sampling into our ICT program is to enhance our efficiency in performing audits that benefits both the State of Virginia as well as the taxpayers.

The procedures set forth in this section will be a guide to be followed by auditors in using statistical sampling methods in sales and use tax audits. Additionally, information contained in these procedures is not confidential in nature and may be used to explain to taxpayers the benefits of using statistical sampling.

II. Starting a Statistical Sample

A. Identifying Good Candidates for a Statistical Sample

A good candidate for a statistical sample should have:

- A large volume of records. Sampling has long been accepted as a valid auditing technique where the volume of records from the taxpayer is too great to do a 100% review. We have traditionally used a block sampling method or a systematic sampling method using ICT in performing sales and use tax audits.
- The taxpayer must have complete records for the audit period. This is a requirement for performing statistical sampling. This is determined using the same standards we have always used found in our original procedures.
- Electronic data. This is a requirement for performing a statistical sample. It is essential that we have an accurate count of the total number of invoices in the population as well the capability to stratify the data on the invoice amount in order to improve sampling efficiency. Electronic data must also be verified to insure that all of the data has been captured
- Good Internal Controls. The auditor should verify that the taxpayer has good internal controls and has been consistent in the determination of the taxability of transactions

B. The Benefits of a Statistical Sample

- Statistical sampling is the most accurate method of sampling. Other sampling methods should be used only if it is not a good candidate described above.

- The process of selecting records for examination is objective. The records in a statistical sample are selected randomly, ensuring that each record has the potential to be reviewed.
- Statistical sampling is much more efficient than other methods of sampling. This is especially true where the taxpayer has large volumes of records. Statistical samples typically require the auditor to look at fewer records and the taxpayer to pull fewer records.

III. STATISTICAL SAMPLING FORMULAS AND EXPLANATIONS

Examining the entire population of records in tax audits is unrealistic given time and resource constraints. Instead we can draw a valid random sample and use the sample results to project a statistically valid estimate. Here follows the methodology to be used in performing a statistical sample.

First, the sample size s is determined as :

$$s = \left\lceil \frac{\left(\sigma \cdot \Phi^{-1} \left(1 - \frac{\alpha}{2} \right) \right)^2}{m^2} \right\rceil$$

The formula for sample size reveals, as intuition would suggest, that the sample size s increases as the margin of error m decreases, as the standard deviation σ increases, or as the significance level α decreases (the inverse of the cumulative distribution function is monotonically increasing in its parameter).

Example:

Suppose we are interested in finding the rate at which sales tax is being incorrectly assessed, and we need to know how many records to randomly sample in order to be 95% sure (0.05 significance level) that our estimate is within 3% of the true error rate. In this case the variable we are trying to estimate (the error rate) is modeled as a Bernoulli¹ random variable. The true standard deviation of a Bernoulli random variable is given by:

$$\sigma = \sqrt{\rho \cdot (1 - \rho)}$$

Where ρ is the probability that the tax was properly paid. Assuming $\rho = 0.5$, we have

$$s = \left\lceil \frac{\left(\frac{\Phi^{-1} \left(1 - \frac{0.05}{2} \right)}{\sqrt{0.5 \cdot (1 - 0.5)}} \right)^2}{0.03^2} \right\rceil = 0.5 \cdot (1 - 0.5) \cdot \left(\frac{1.96}{0.03} \right)^2 = 1067.11$$

which should be rounded up to a sample size of 1068.

¹ A Bernoulli random variable takes the value 1 with probability of success ρ and 0 with failure probability $1-\rho$.

The following table shows how large the random sample should be for different combinations of confidence and margin of errors, and assuming a 50% probability of an event occurring².

		Confidence Interval						
		70%	75%	80%	85%	90%	95%	99%
Margin of Error	5.0%	108	133	165	208	271	385	664
	4.5%	133	164	203	256	335	475	820
	4.0%	168	207	257	324	423	601	1,037
	3.5%	220	271	336	423	553	784	1,355
	3.0%	299	368	457	576	752	1,068	1,844
	2.5%	430	530	657	829	1,083	1,537	2,654
	2.0%	672	828	1,027	1,296	1,691	2,401	4,147
	1.5%	1,194	1,471	1,825	2,303	3,007	4,269	7,373

The sample sizes above can also serve as a baseline for sampling a continuous variable, as in the case of a dollar amount (for our purposes, a tax assessment –or credit. Here, m is the acceptable margin of error, in dollars, of the tax assessment).

After conducting the random sample, we should make sure that sample size was sufficiently large to achieve the desired combination of margin of error and confidence interval. To do so we re-calculate the sample size using the statistics collected from the sample. The procedure is illustrated below first for a simple random sample and then for a stratified random sample.

A. Baseline: Simple Random Sample

Suppose we take a random sample of 1,068 out of a total population of 20,000 and we find that tax is underpaid in the sample by an average \$20 per item³. Then the projected total error is simply $\$20 \cdot 20,000 = \$400,000$. Suppose the sample standard deviation $\hat{\sigma}$ of underpayment is \$7.5⁴. For a simple random sample, the projected standard deviation of the total underpayment in the population is simply $\hat{\sigma} \cdot n$, or $\$7.5 \cdot 20,000 = \$150,000$ in this example. We

² Note that this is the most conservative figure because it maximizes the sample size. If we had prior information that made us believe that the responses were more skewed, say 75%, then our sample size wouldn't have to be as big (800 in our example above).

³ The sample average \bar{x} is given by $\bar{x} = \frac{1}{n} \cdot \sum_{i=1}^n x_i$ where x_i is the underpayment and n is the sample size.

⁴ The sample standard deviation $\hat{\sigma}$ is given by $\hat{\sigma} = \sqrt{\frac{1}{n-1} \cdot \sum_{i=1}^n (x_i - \bar{x})^2}$

want to be 95% confident that, under repeated sampling, the \$400,000 tax assessment is within \$12,000 of the true tax owed (a 3% margin of error).

$$s = \left\lceil \frac{150,000 \cdot \left(\Phi^{-1} \left(1 - \frac{0.05}{2} \right) \right)^2}{12,000} \right\rceil = (12.5 \cdot 1.96)^2 = 600.25$$

Thus we find that a sample size of 601 would have met the precision goal. In fact, in this specific example we can be 95% confident that the tax assessment is within \$8,996 of the true tax owed⁵, a margin of error of about 2.25%. If we find that our goal was not met, we could either change our goals (in discussion with the taxpayer we can decide to increase the margin of error or the significance level) or draw a larger sample of magnitude equal to the recalculated sample size.

B. Stratified Random Sample

While it is perfectly valid to draw a simple random sample from the entire population, stratified random sampling is more efficient (sample size being equal, you are more likely to reach your precision goals if you stratify). The method of stratified sampling is one where the population is divided into strata (i.e., based on dollar amounts). We have chosen to stratify the audit population into 5 strata. We use a 100% sampling rate on the highest dollar stratum. We sample 267 records (1068 divided by 4) in each of the other 4 strata. While it is valid to judgmentally determine the stratum cutoffs, our preferred method is to give each stratum equal weight by total dollars. Typically, this increases efficiency through a higher sampling rate for the strata containing high dollar items.

The average error amount in each stratum is used to project a total error. We can project each stratum separately and then add them up for a total. Alternatively, we can use the relative number of records in each stratum to calculate a weighted average error amount and then multiply by the population size to arrive at a tax assessment estimate.

To illustrate, suppose we stratified the population into four strata of equal dollar weight as follows: 8,000 records in the lowest dollar records stratum, 4,000 in the second, 2,000 in the third, and 1,000 in the fourth. Suppose we then sampled 267 from each stratum and found an average underpayment of \$1 in stratum one, \$5 in stratum two, \$20 in stratum three, and \$100 in stratum four, with corresponding standard deviations of \$0.2, \$1, \$2, and \$5. The fifth, the highest dollar stratum resulted in a tax assessment of \$200,000 (true, not estimated. The standard deviation is zero of course). The projected total tax assessment is then:

$$\$200,000 + (8,000 \cdot \$1) + (4,000 \cdot \$5) + (2,000 \cdot \$20) + (1,000 \cdot \$100) = \$368,000$$

⁵ Rearranging the sample size formula, we get $m = \frac{\sigma \cdot \Phi^{-1} \left(1 - \frac{\alpha}{2} \right)}{\sqrt{s}} = \frac{150,000 \cdot 1.96}{\sqrt{1068}} = \$8,996$

or alternatively found using a weighted average:

$$\$200,000 + 15,000 \cdot \left(\frac{8}{15} \cdot 1 + \frac{4}{15} \cdot 5 + \frac{2}{15} \cdot 20 + \frac{1}{15} \cdot 100 \right) = \$200,000 + 15,000 \cdot \$11.2 = \$368,000$$

In a stratified random sample, the projected standard deviation of the total error in the population is found as:

$$\hat{\sigma} = \sqrt{\sum_{i=1}^4 N_i \cdot (N_i - n_i) \cdot \frac{\hat{\sigma}_i^2}{n_i}}$$

Where N_i is the total number of records in stratum i and n_i is the number of records sampled in stratum i (267). In our stratified random sample example above,

$$\hat{\sigma} = \sqrt{\left(\frac{8,000 \cdot (8,000 - 267) \cdot \frac{\$0.2^2}{267} \right) + \dots + \left(\frac{1,000 \cdot (1,000 - 267) \cdot \frac{\$5^2}{267} \right)} = \$185,751$$

Now we can determine whether the sample of 1,068 was large enough. We want to be 95% confident (0.05 significance level) that, under repeated sampling, this \$368,000 tax assessment is within \$11,040 of the true tax owed (a 3% margin of error).

$$s = \left\lceil \frac{\Phi^{-1}\left(1 - \frac{0.05}{2}\right)}{\frac{11,040}{185,751}} \right\rceil^2 = (16.3 \cdot 1.96)^2 = 1,088$$

Thus we find that a sample size of 1088 is needed to meet the precision goal. We are left with the choice of sampling 20 more records or simply accept a slightly higher error rate –in this example, we can be 95% confident that the tax assessment is within \$11,140 of the true tax owed⁶, a margin of error of about 3.03%.

IV. GLOSSARY OF RELATED TERMS

Random Sampling: For a simple random sample, each item in the population has the same probability of being sampled. In stratified random sampling, each item in each stratum has the same probability of being sampled (but the probability might differ among strata).

Stratified Random Sampling: The population is divided into strata. A random sample is taken from each stratum. Stratifying the population based on dollar

⁶ Rearranging the sample size formula, we get $m = \frac{\lceil \Phi^{-1}\left(1 - \frac{\alpha}{2}\right) \rceil^2}{\sqrt{s}} = \frac{185,751 \cdot 1.96}{\sqrt{1068}} = \$11,140$

amounts can provide for more precise results as compared to a simple random sample of the entire population, the reason being that in a simple random sample low dollar items have a higher probability of being sampled.

⁶ Rearranging the sample size formula, we get
$$m = \frac{t^2 \cdot \sqrt{pq} \left(1 + \frac{z}{2}\right)}{\sqrt{s}} = \frac{185,751 \cdot 1.96}{\sqrt{1068}} = \$11,140$$

Weighted Average: When the weights are the same, weighted average is the same as a simple arithmetic average. Weighted averages take into consideration the frequency of the class of records in order to compute an average. For example, consider a population divided into two strata, one with the 100 highest dollar records and one with 900 records. If the average tax assessment was found to be \$50 for the high dollar items and \$1 for the low dollar items, then the weighted average is $5.9 \left(\frac{100}{1000} \cdot 50 + \frac{900}{1000} \cdot 1 \right)$.

Projection: Projection is expanding the sample results to the entire population. To arrive at an estimate of total assessment, multiply the average error value in each stratum's random sample by the number of items in that stratum. The total population estimate is simply the sum of each stratum's projected error. This is algebraically identical to the result obtained from multiplying a weighted average of the strata's assessment by the total number of records in the population.

V. DEVELOPING THE STATISTICAL SAMPLE

An important point needs to be made here. The field auditor is in charge and is responsible for their individual audits. The ICT auditor's position is that of a consultant who is responsible for manipulating data to achieve an efficient and workable sample for the field auditor to use.

A. Review and Verification

The taxpayer should send the records to the field auditor. It is the responsibility of the field auditor to review the records to determine if they received the information they requested. The field auditor should verify that the account balances are correct and is in agreement with the G/L for the period, to assure that all records have been received.

The field auditor should also review the file to assure there is no incorrect information and that there are no blank fields in the file or extra rows with any additional information.

B. Sampling Form

One of the primary responsibilities of the field auditor will be to determine if the ICT program can be used for conducting an audit. The field auditor, during the initial audit conference and/or upon first arriving at the audit site, must ask the taxpayer if they can use the ICT program to develop the sample for the audit. The field auditor must complete the ICT justification form below for each prospective audit, (blank copy enclosed for reference).

The questions are to be asked of the taxpayer by the field auditor.

- Can records be provided in electronic data format in Excel spreadsheet or similar type format?
- Approximately how many records will be provided/
- What is the audit period to be covered?
- If ICT cannot be used, explain why it cannot.
- Give any additional information, and /or explanations as to how the auditor will use the ICT audit program, or why it cannot be used.

The field auditor will be required to complete this form for each audit. Once completed, the field auditor should scan the document into their audit folder in STAUDN and keep the paper copy in their audit folder (**See Form 1**).

Form 1

ICT Information Form

Acct #: <Account #> Contact: <Contact Name>

Name: <Business Name> Title: <Contact Title>

Date: <Date> Auditor: <Auditor Name>

PURPOSE: To document the use of Excel and IDEA software applications in the audit. To be completed by auditor prior to starting the audit field work.

- The use of ICT was discussed with the customer contact listed above. In addition, the customer was given a copy of the ICT Taxpayer Explanation handout. **(Required for ALL audits)**
- After discussion with my team lead or audit supervisor, it was determined that this audit case is not a good candidate for ICT because: (Mark all that apply – Explain as necessary)
 - Customer is not fully computerized
 - Prior audit history (company size / hours) not sufficient to utilize ICT procedures
 - Customer declines to use ICT procedures
 - Other/Explanation:
- The customer is interested in using ICT. The customer: (Mark all that apply – Explain as necessary)
 - Cannot** provide data in Excel or other suitable format
 - Can** provide data for at least one audit measure in Excel or other suitable format
 - Agrees to use ICT procedures for this audit
 - Other/Explanation:

If ICT to be used, provide the following information for each prospective ICT measure, account #, etc:

Data Available	Measure Name, Acct # or Description	ICT Use Expected	Sample Period	Approx. # of Records
Yes <input type="checkbox"/> No <input type="checkbox"/>	Sales	Yes <input type="checkbox"/> No <input type="checkbox"/>		
Yes <input type="checkbox"/> No <input type="checkbox"/>	Assets	Yes <input type="checkbox"/> No <input type="checkbox"/>		
Yes <input type="checkbox"/> No <input type="checkbox"/>	Purchases	Yes <input type="checkbox"/> No <input type="checkbox"/>		
Yes <input type="checkbox"/> No <input type="checkbox"/>	Other	Yes <input type="checkbox"/> No <input type="checkbox"/>		
Yes <input type="checkbox"/> No <input type="checkbox"/>	Other	Yes <input type="checkbox"/> No <input type="checkbox"/>		

Additional Comments:

C. Manipulating the Data

Once the ICT auditor has received the file from the field auditor, it is their responsibility to develop the statistical sample. The ICT auditor will use the Procedures set forth in the following section to produce the statistical sample. The ICT auditor should evaluate the information received, to assure that a statistical sample can be done, and identify any extraordinary issues that need to be resolved before a sample is developed.

D. File Formats used by ICT

The ICT software (IDEA) can work effectively with a wide may of data formats. These formats include:

Application Data and Databases

Access •	Excel
Lotus 123 •	SQL Server
Oracle •	Sybase
Various accounting packages including •	XBASE (the DBF format from dBase,
Accpac, Simply Accounting, Pegasus Sage and many others,	Foxpro, and others)
Btriev	

Flat Files /Unformatted Data

ASCII (fixed length and variable length) •	ASCII Delimited
EBCDIC (fixed length) •	EBCDIC (variable length ANSI/IBM)
AS/400 DIF (Data Interchange Format)	

Most software applications can effectively export a flat, or ASCII, file type. The ICT auditor should work with the taxpayer **to** identify a usable file format.

See page three of the ICT Procedure Manual for further information.

VI. STATISTICAL SAMPLING PROCEDURES

When developing a statistical sample from virtually any size file of records, the auditor will use the following procedures to select a sample from the original population of records:

Initially, a detailed stratification should be done. All negative amounts should be extracted out with only positive amounts remaining in the population. The negative amounts can be reviewed separately. The auditor will use a total of 1068 records as specified by the table in Section 3. This is based on a Confidence level of 95% and a Margin of Error of 3%. The highest dollar stratum will be reviewed in detail. For the remaining stratum, other than the highest dollar stratum, four equally weighted

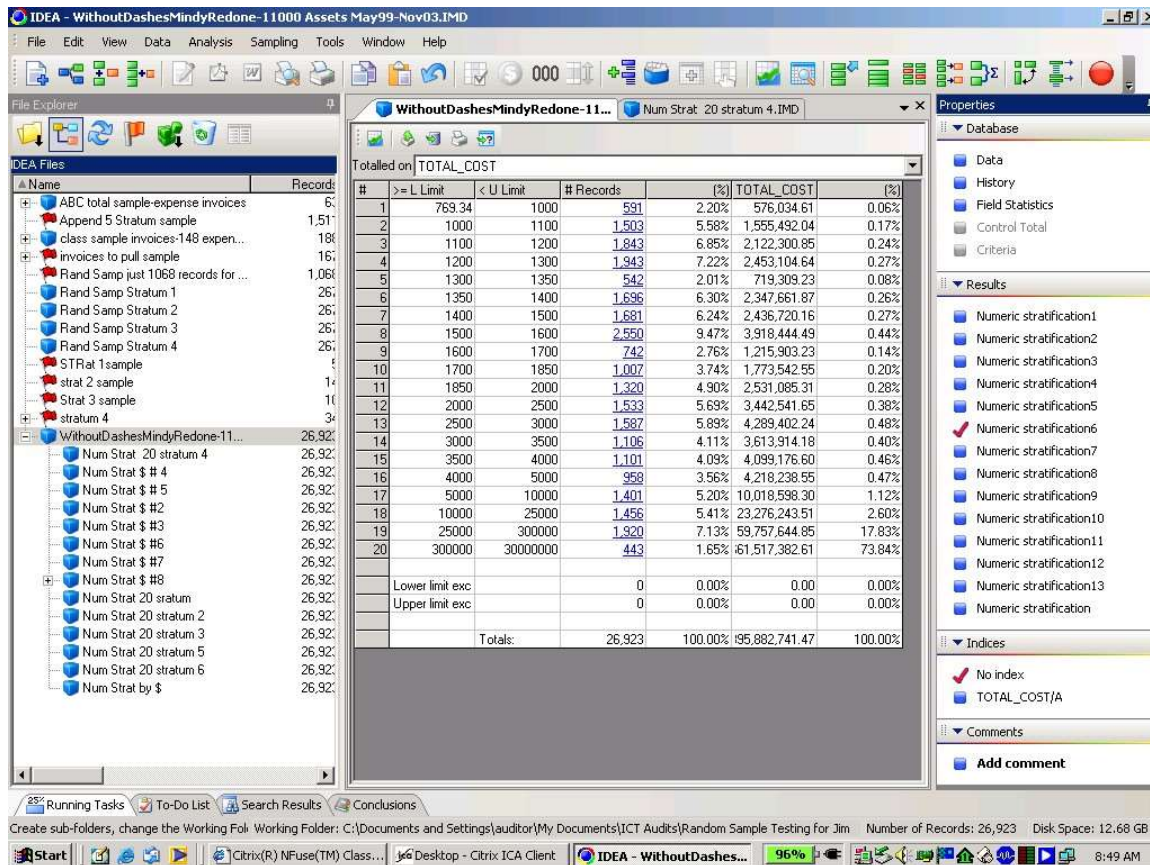
stratums should be developed. For each of the four stratums 267 records will be selected as the sample. This totals the 1068 records that should be used

NOTE: Obviously some audits will not have enough records to support reviewing 1068 records. In this case, the auditor should use the alternative sampling methods of ICT systematic sampling or block sampling.

A. Detailed Stratification

A detailed stratification is a very important step in arriving at four equally weighted averages. This may mean that you have as many as 20 or more stratums. Each stratum should be finely defined so that we can develop the most accurate sample that we can (See Fig. 1).

Figure 1



B. Number of Records to Sample

Based on the statistical table in Section 3, when developing a statistical sample we will review a total of 1068 (not counting the highest dollar records). This sample size can be used for any population of records unless the population is too small to support reviewing this many records. The 1068 records will be selected from the final four stratums and the number of records of the high dollar stratum will be added to this for the total sample.

C. Detail Highest Dollar Stratum

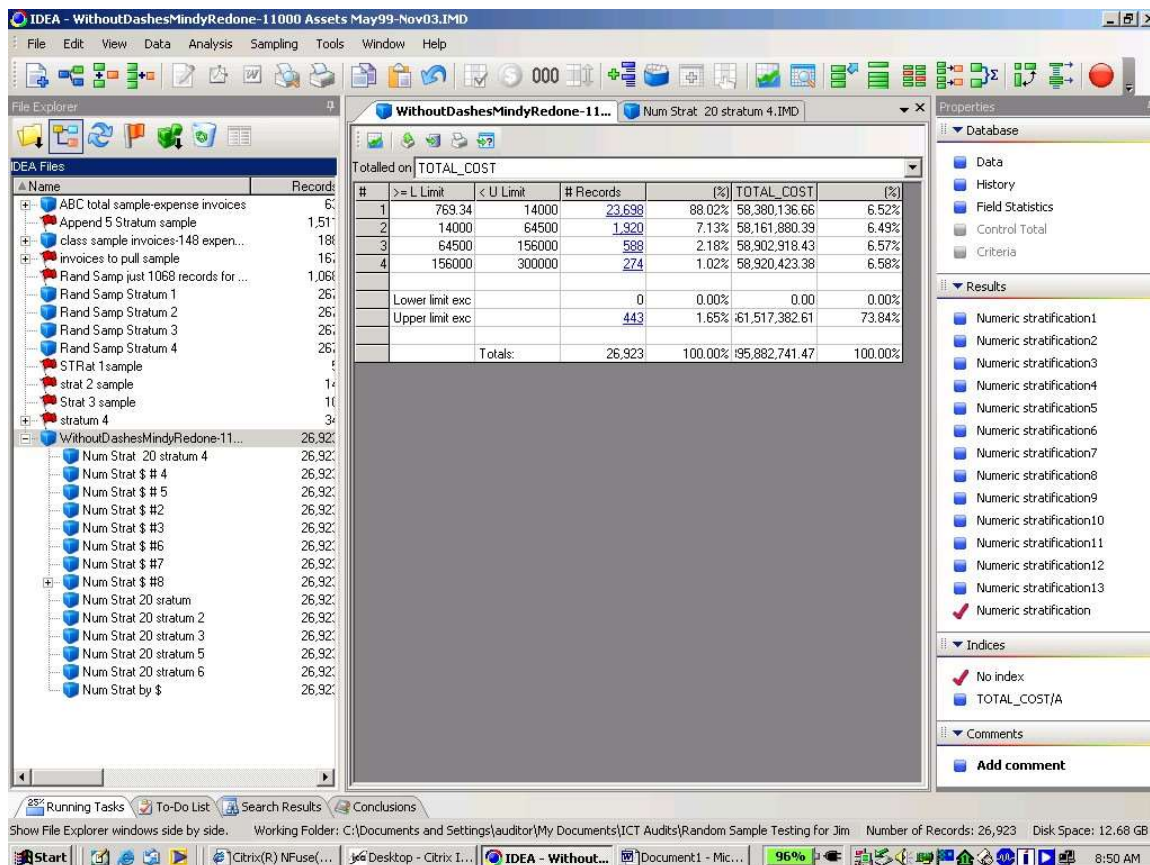
The highest dollar stratum will always be reviewed in detail. Whether you are sampling expense purchases or assets, it is important to segregate the highest

dollar for review. This assures that in reviewing the high dollar level the auditor can be assured that the taxpayer and the State of Virginia are not subject to any abnormal error created by extrapolating from a smaller sample.

D. Developing Four Stratum

To develop four stratum it will be necessary to take the remaining stratum from the detailed stratification and use the percentages of the total dollars (farthest right column), then total all of the percentages and divide by four. This will give you your weighted average for each stratum. For example in **Figure 2** below, the total of the percentages was 26.06%. Divided by 4 this would be approximately 6.52%. That means that each stratum should contain as close to 6.52% of the total dollars of your remaining stratum. This will be achieved by starting at the first stratum and, based on the percent of total dollars, add the stratum together until they equal close to 6.52%. That ends your first stratum. Repeat for the other three stratum. Once the auditor completes this step, and then the auditor would rerun the stratification with the four new stratum. Now that you have your four stratum you are ready to draw your samples from the stratum using the Stratified Random Sampling Program.

Figure.2



VII. STATISTICAL SAMPLING PROCEDURES

From your four stratum, using the stratified random sampling program, the auditor will select 267 records from each stratum and create a file. The auditor will then append these four files to the high dollar level file to create your total sample, (See **Figure 3** below). By using 267 for each stratum, it will give you the total of 1068 records, which will be used in the statistical sampling procedure. An important note to follow in each stratum IDEA will give you a seed number. The auditor is to use the seed number the program provides for each stratum. The seed number is stored in your History and cannot be removed. This is important in case you should need to draw your 267 records from a stratum a second time.

Once the auditor has selected the sample from the four stratum, the auditor will need to append them to the file of the high dollar records to provide the one sample. Generally speaking the auditor should have a total sample of the 1068 records plus between 200 to 800 records for the high dollar file. When the auditor has appended all of the files, the auditor can then export the file back to the field auditor who can use it to begin their fieldwork.

Figure 3

The screenshot displays the IDEA software interface. The main window shows a data table with the following columns: BUSINESS_UNIT, DEPARTMENT, GL_ACCOUNT, PROFILE, and ASSET. The data rows are numbered 1 through 35. The table is filtered to show records with BUSINESS_UNIT 11000 and DEPARTMENT 15201. The ASSET column contains values ranging from 6142 to 6175. The interface also includes a File Explorer on the left showing a tree view of IDEA files, a Properties panel on the right with sections for Database, Results, Indices, and Comments, and a status bar at the bottom indicating the working folder and number of records.

Record #	BUSINESS_UNIT	DEPARTMENT	GL_ACCOUNT	PROFILE	ASSET
1	11000	14300	15030000	LTP	CNV0000
2	11000	15201	15030000	PCEQ	6142
3	11000	15201	15030000	PCEQ	6143
4	11000	15201	15030000	PCEQ	6144
5	11000	15201	15030000	PCEQ	6145
6	11000	15201	15030000	PCEQ	6146
7	11000	15201	15030000	PCEQ	6147
8	11000	15201	15030000	PCEQ	6148
9	11000	15201	15030000	PCEQ	6149
10	11000	15201	15030000	PCEQ	6150
11	11000	15201	15030000	PCEQ	6151
12	11000	15201	15030000	PCEQ	6152
13	11000	15201	15030000	PCEQ	6153
14	11000	15201	15030000	PCEQ	6154
15	11000	15201	15030000	PCEQ	6155
16	11000	15201	15030000	PCEQ	6156
17	11000	15201	15030000	PCEQ	6157
18	11000	15201	15030000	PCEQ	6158
19	11000	15201	15030000	PCEQ	6159
20	11000	15201	15030000	PCEQ	6160
21	11000	15201	15030000	PCEQ	6161
22	11000	15201	15030000	PCEQ	6162
23	11000	15201	15030000	PCEQ	6163
24	11000	15201	15030000	PCEQ	6164
25	11000	15201	15030000	PCEQ	6165
26	11000	15201	15030000	PCEQ	6166
27	11000	15201	15030000	PCEQ	6167
28	11000	15201	15030000	PCEQ	6168
29	11000	15201	15030000	PCEQ	6169
30	11000	15201	15030000	PCEQ	6170
31	11000	15201	15030000	PCEQ	6171
32	11000	15201	15030000	PCEQ	6172
33	11000	15201	15030000	PCEQ	6173
34	11000	15201	15030000	PCEQ	6174
35	11000	15201	15030000	PCEQ	6175

Credits within a Sample

As a result of sampling, the auditor may encounter records where the taxpayer has paid tax to a vendor erroneously or they have accrued tax and paid it to the state erroneously. Regardless of which situation occurs, the auditor cannot remove the record from the sample and replace it with another record. Credits remain in the sample but each situation is handled in a different manner.

If the taxpayer has paid tax to a vendor erroneously, the record would be marked exempt (E) and the taxpayer would be told that they need to be refunded from the vendor for that invoice and any other like invoice.

If the taxpayer has accrued tax and remitted it to the state, then the auditor would treat this record in one of two methods. First, if the taxpayer wants to extrapolate the credit through the audit, then the auditor would mark this particular record that will be held in the audit as part of the final assessment record as taxable (T), but it would have a credit value. This would offset taxable exceptions held in the audit that creates an assessment. It would be extrapolated to the extent that the entire sample is extrapolated. If the taxpayer chooses this method, then they would have no claims for refund on any other invoices not sampled in the audit period.

If the taxpayer elects not to include the credit in the sample, then the auditor would mark the record as exempt (E). The taxpayer would then be able to review all invoices that are in statute and submit a refund request to the Department of Taxation.

VIII. STATISTICAL SAMPLING PROCEDURES

Since the goal of using statistical sample is to capture all records for the audit period. It will only be necessary to gross up the error factor created from the sample by the total dollar value of the entire population. The ICT auditor, when entering data into STAUDN, can manipulate this information along with the exceptions noted.

If the sample period is less than the entire audit period, then the procedures above would be used and in addition the auditor would have to further extrapolate the results in STAUDN to determine the total assessment. The ICT auditor can manipulate the data in this situation as well to upload the data into STAUDN.